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THE BROOKINGS REVIEW

Spring 1987 Vol. 5, No. 2

3 **Blundering Into Disaster: The First Century of the Nuclear Age**
Robert S. McNamara

10 **Why the Soviets Are Serious About Arms Control**
Michael MccGwire

20 **Getting Back on Track: An Economic Overview**
George L. Perry

28 **The External Deficit: Why? Where Next? What Remedy?**
Ralph C. Bryant and Gerald Holtham

37 **The Investment Climate in China**
Harry Harding

43 **The Politics of Blame**
R. Kent Weaver

48 **New Publications**
Paul E. Peterson, Barry G. Rabe, and Kenneth K. Wong on federal aid; Joshua M. Epstein on military strategy and force planning in the Persian Gulf.

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Blundering Into Disaster: The First Century of the Nuclear Age

Robert S. McNamara

IS THE RISK of nuclear war unacceptably high and, if so, what can we do about it? Will Reykjavik prove to be a step toward reducing that risk?

Let me begin by recalling that nearly 50 years have passed since Albert Einstein sent his historic letter to President Franklin D. Roosevelt warning him that it was essential that the United States move quickly to develop the nuclear bomb. In that half century the world's inventory of such weapons has increased from zero to 50,000. On average, each of them has a destructive power 30 times that of the Hiroshima bomb. A few hundred of the 50,000 could destroy not only the United States, the Soviet Union, and their allies but, through atmospheric effects, a major part of the rest of the world as well.

The weapons are widely deployed. They are supported by war-fighting strategies. Detailed war plans for their use are in the hands of the field commanders. And the troops of each side routinely undertake exercises specifically designed to prepare for that use. General Bernard Rogers, the supreme allied commander of NATO forces in Europe, has said it is likely that in the early hours of a military conflict in Western Europe, he would ask for the authority to initiate use of nuclear weapons.

This situation has evolved over the years through a series of incremental decisions. I myself participated in many of them. Each of the decisions, taken by itself, appeared rational or inescapable. But the fact is that each was made without reference to any overall master plan or long-term objective. Together these decisions have led to nuclear arsenals and nuclear war plans that few of the participants either anticipated or, in retrospect, would wish to support.

Because we lack a long-run plan for the nuclear age, the number of weapons continues to multiply. And now the United States and the Soviet Union appear to be on the verge of an escalation of the arms race that will not only place weapons in space, but will seriously increase the risk that one or the other of the adversaries will be tempted in a period of tension to initiate a preemptive nuclear strike before the opponent can get in the first blow.

Although four decades have passed without the use of nuclear weapons, and though it is clear that both the United States and the USSR are aware of the dangers of nuclear war, it is equally true that for thousands of years the human race has engaged in war. There is no sign that is about to change. And history is replete with examples of occasions in such wars when emotions have taken hold and replaced reason.

I do not believe the Soviet Union wants war with the West. And certainly the West will not attack the USSR or its allies. But dangerous frictions between East and West have developed in the past and are likely to do so in the future. If deterrence fails and conflict develops, the present Western strategy carries with it a high risk that civilization will be destroyed.

Robert S. McNamara, a member of the Brookings Board of Trustees, is a former president of Ford Motor Co., secretary of defense, and president of the World Bank. *This article is based on the book* Blundering Into Disaster: Surviving the First Century of the Nuclear Age *by Robert S. McNamara.* *Copyright © 1986 by Robert S. McNamara. Reprinted by permission of the publisher, Pantheon Books, a division of Random House, Inc.*

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"The risk that military conflict will quickly evolve into nuclear war, leading to certain destruction of our civilization, is far greater than I am willing to accept. . . ."

Crisis Instability and the Risk of Nuclear War

During the seven years I served as secretary of defense, confrontations carrying a serious risk of military conflict developed on three separate occasions: over Berlin in August of 1961; over the introduction of Soviet missiles into Cuba in October of 1962; and in the Middle East in June of 1967. In none of these cases did either side want war. In each of them we came perilously close to it.

In no one of the three incidents did either side intend to act in a way that would lead to military conflict, but on each occasion lack of information, misinformation, and misjudgments led to confrontation. And as each crisis evolved, tensions heightened, emotions rose, and the danger of irrational decisions increased.

It is correct to say that no well-informed, coolly rational political or military leader is likely to initiate the use of nuclear weapons. But political and military leaders, in moments of severe crisis, are likely to be neither well informed nor coolly rational.

Today we face a future in which for decades we must contemplate continuing confrontation between East and West. Any one of these confrontations can escalate, through miscalculation, into military conflict. And that conflict will be between blocs that together possess 50,000 nuclear warheads — warheads that are deployed on the battlefields and integrated into the war plans. A single nuclear-armed submarine of either side can unleash more firepower than man has shot against man throughout history.

In the tense atmosphere of a crisis, each side will feel pressure to delegate authority to fire nuclear weapons to battlefield commanders. As the likelihood of attack increases, these commanders will face a desperate dilemma: use the weapons or lose them. And because the strategic nuclear forces, and the complex systems designed to command and control them, are perceived by many to be vulnerable to a preemptive attack, commanders will argue the advantage of a preemptive strike.

But it is a fact that in the face of the Soviet nuclear forces the West has not found it possible to develop plans for the use of its own nuclear weapons in a conflict with the USSR in ways that would both assure a clear advantage to the West and at the same time avoid the very high risk of escalating to all-out nuclear war.

What would be the consequences of such a conflict?

Studies by two of my former aides in the Pentagon concluded that even under the most favorable assumptions, there would be a high risk of 100 million dead. Such studies prompted former West German Chancellor Helmut Schmidt to remark that the use of nuclear weapons will not defend the West, but destroy it. And they led Field Marshal Lord Richard Carver, Lord Louis Mountbatten, and several other of the eight retired chiefs of the British Defense Staff to indicate that under no circumstances would they have recommended that the West initiate the use of nuclear weapons in a confrontation with the Soviet Union.

The risk that military conflict will quickly evolve into nuclear war, leading to certain destruction of our civilization, is far greater than I am willing to accept on military, political, or moral grounds. And, I submit, it is far greater than anyone should be willing to continue to accept.

The conviction that the superpowers must change course is shared by groups and individuals as diverse as the antinuclear movements, the majority of the world's top scientists, Soviet General Secretary Mikhail Gorbachev and President Ronald Reagan, and leaders of third world and independent nations such as Rajiv Gandhi of India and the late Olof Palme of Sweden. All agree that we need a plan to reduce the long-term risk of nuclear war, but there is no consensus on what course to take. The changes of directions being advocated follow from very different diagnoses of our predicament.

Before examining proposals for changing course, it should be emphasized that if the superpowers continue to weaken the arms control regime, as they have over the past six or seven years, the risk of the world ultimately facing a nuclear conflagration will continue to grow. Miniaturization is increasing the mobility, accuracy, and destructive power of weapons. In advanced stages of development are mobile land-based missiles; antisatellite weapons; space-based systems; and land-, sea-, and air-based cruise missiles that are increasingly difficult to detect and hence increasingly difficult to limit by verifiable arms control agreements.

The current U.S. nuclear weapons-building program, which is producing 2,000 warheads annually, is the biggest in 20 years. And steps are under way to expand substantially for the 1990s both the production of the key nuclear materials — tritium, uranium, and plutonium — and the production of the warheads themselves. At the same time,

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our weapons laboratories are forecasting large increases in the number of underground tests required for the development of new types of nuclear arms.

Unconstrained weapons development and deployment over the next 50 years will lead not only to increased numbers of weapons but to greater danger of their use in time of tensions, that is, greater "crisis instability."

Risk Reduction Proposals

It is the recognition of this danger that has led President Reagan, General Secretary Gorbachev, and others to suggest actions that they hope will reduce the long-term risk of nuclear war. The proposals they have presented include:

- Achieving political reconciliation between East and West.
- Eliminating all nuclear weapons through negotiation (as proposed by Gorbachev).
- Replacing "deterrence" with "defense" — the elimination of nuclear weapons by the substitution of defensive forces for offensive forces (as proposed by Reagan).
- Strengthening deterrence by adding defensive forces to the offense (as proposed by former Secretary of State Henry Kissinger and others).
- Accepting the proposition that nuclear warheads have no military use whatsoever except to deter one's opponent's use of such weapons.

Do any of these alternatives offer hope that the risk of nuclear war can be significantly reduced in the second half century of the nuclear age?

Before discussing the choices we face, we should erase from our minds a series of misperceptions of the nuclear balance between East and West that are widespread, both in America and throughout the world. They include such commonly held views as:

"It is clear that the West . . . lacks an agreed conceptual framework for the management of relations with the Soviet Union and its allies."

- The Soviets possess nuclear forces superior to our own.
- The Soviets possess, or are seeking to achieve, a first-strike capability.
- Regardless of American actions or restraint, the Soviets will continue to expand their nuclear power as quickly as they can for as long as they can.
- If the West mobilizes its technical resources, it can achieve and maintain a militarily significant lead over the Soviets.
- Given the political confrontation between East and West, the buildup of nuclear forces to their present levels was inevitable.
- Arms control agreements are worthless; the Soviets cheat and their violations are undetectable.
- Arms control agreements have only resulted in Soviet advances.
- Nuclear weapons, even when militarily irrelevant, may serve political ends.

All of these statements are incorrect. But the arms race in the first half century of the nuclear age has been fueled in part by myths such as these.

Let me now turn to a discussion of alternatives to a continuation of the arms race. I begin with East-West reconciliation.

East-West Reconciliation

The East-West military rivalry is, of course, a function of the political conflict that divides the two blocs. Many have argued, therefore, that any long-term attempt to bring a halt to the arms race and to reduce the risk of nuclear war must begin by addressing the source of the tensions — the political rivalry.

It is clear that the West — North America, Western Europe, and Japan — lacks an agreed conceptual framework for the management of relations with the Soviet Union and its allies.

We need a coherent, widely supported policy, rooted in reality and pressed with conviction and determination. It must be a policy that protects vital interests, enhances political cohesion, and offers the hope of influencing the Soviets to move in a favorable direction. A long-term, stable relationship between East and West is both desirable and attainable. Even in an atmosphere of competition and mutual suspicion, common interests exist, and the pursuit of each side's competitive goals can take place in an atmosphere of moderation.

The relationship must rest on the twin pillars of firmness and flexibility. Both of these elements are essential if the relationship is to command public support and have a chance of succeeding. There is not a contradiction here: détente without defense would amount to surrender on the installment plan; defense without détente would increase tensions and the risk of conflict. The two are mutually reinforcing.

Therefore, I strongly urge that we embark upon a program of "sustained engagement." It cannot be stressed enough, however, that this process will require time, patience, and consistency of purpose. And there are limits to the results. Sustained engagement cannot be expected to eliminate the periods of tension and confrontation that have characterized East-West relations over the past four decades. It is not, therefore, a substitute for other actions

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"Unless we can develop technologies and procedures to ensure detection of any steps toward building a single nuclear bomb by any nation or terrorist group, an agreement for total nuclear disarmament will almost certainly degenerate into an unstable rearmament race."

designed to reduce the risk that military conflict, rising out of such confrontation, will lead to the use of nuclear weapons. Steps to control directly and reverse the arms race must go forward in parallel with efforts to reduce political tension.

I turn next, therefore, to consideration of the four different approaches to controlling directly the "volume" and "use" of such weaponry.

Gorbachev: Eliminate All Nuclear Weapons

General Secretary Gorbachev has proposed that the United States and the Soviet Union aim at achieving the total elimination of nuclear weapons by the year 2000.

Is a nuclear-free world desirable? I believe it is, and I think most Americans would agree.

However, NATO's current military strategy and war plans are based on the opposite premise. And many — I would say most — U.S. military and civilian officials, as well as European leaders, hold the view that nuclear weapons are a necessary deterrent to Soviet aggression with conventional forces. Thus, these individuals do not favor a world without nuclear weapons. Zbigniew Brzezinski, President Jimmy Carter's national security advisor, said of Gorbachev's proposal, "It is a plan for making the world safe for conventional warfare. I am therefore not enthusiastic about it."

My criticism of Gorbachev's vision, however, is not that it is undesirable, but that it is infeasible under foreseeable circumstances. Unless we can develop technologies and procedures to ensure detection of any steps toward building a single nuclear bomb by any nation or terrorist group, an agreement for total nuclear disarmament will almost certainly degenerate into an unstable rearmament race. Thus, despite the desirability of a world without nuclear weapons, an agreement to that end does not appear feasible either today or for the foreseeable future.

Reagan: Substitute Defensive Forces for Offensive Forces

On March 23, 1983, President Reagan proposed his solution to the problem of security in the nuclear age. He launched the Strategic Defense Initiative (SDI), a vast program that promised to create an impenetrable shield to protect the entire nation against a missile attack. With the shield in place, the president argued, the United States would be able to discard not just nuclear deterrence but nuclear weapons themselves.

The president and his secretary of defense, Caspar W. Weinberger, continue to promise that this strategic revolution is at hand.

Virtually all others associated with the Strategic Defense Initiative have recognized and admitted that such a leakproof defense is so far in the future, if indeed it ever proves feasible, that it offers no solution to our present dilemma. Therefore, they advocate missions for a Star Wars system other than a perfect "security shield." These alternative aims range from defense of hardened targets — for example, missile silos and command centers — to partial protection of our populations.

For the sake of clarity I will call these alternative programs Star Wars II, to distinguish them from the president's original proposal, which will be labeled Star Wars I. (A third, quite different version of the SDI, which might be called Star Wars III, was put forward at Reykjavik.)

It is essential to understand that Star Wars I and Star Wars II have diametrically opposite objectives. The president's program, if achieved, would substitute defensive for offensive forces. In contrast, Star Wars II systems have one characteristic in common: they would all require that we continue to maintain offensive forces but add the defensive systems to them.

Until there are inventions that have not yet been imagined, a defense robust and cheap enough to replace

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deterrence will remain a pipe dream. Given that harsh reality, President Reagan's claims that defensive forces are "morally preferable" to offensive forces and that we have a "moral obligation" to pursue them are, as former Secretary of Defense James R. Schlesinger has put it, "pernicious." Thus, "mutual assured destruction" is not, as some have alleged, an immoral policy. Mutual assured destruction — the vulnerability of each superpower to the awesome destructive power of nuclear weapons — is not a policy at all. It is a grim fact of life.

Strengthen Deterrence

Henry Kissinger agrees that achievement of Star Wars I in any time period relevant to the current problem is impossible. But Kissinger has become a supporter of Star Wars II. He believes that deploying strategic defenses while maintaining our offensive systems will strengthen deterrence.

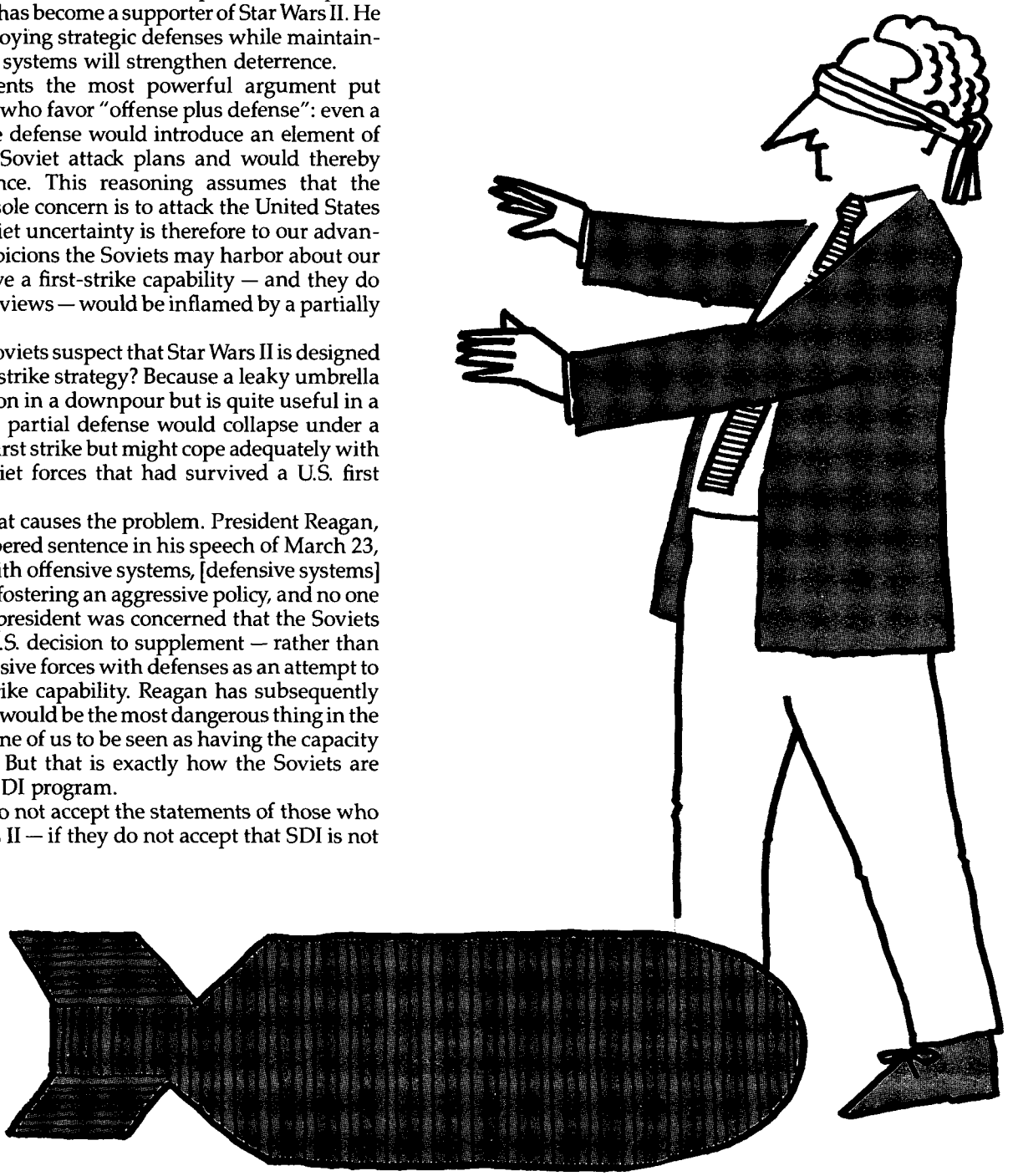
Kissinger presents the most powerful argument put forward by those who favor "offense plus defense": even a partially effective defense would introduce an element of uncertainty into Soviet attack plans and would thereby enhance deterrence. This reasoning assumes that the Soviet military's sole concern is to attack the United States and that any Soviet uncertainty is therefore to our advantage. But any suspicions the Soviets may harbor about our wishing to achieve a first-strike capability — and they do indeed hold such views — would be inflamed by a partially effective defense.

Why will the Soviets suspect that Star Wars II is designed to support a first-strike strategy? Because a leaky umbrella offers no protection in a downpour but is quite useful in a drizzle. That is, a partial defense would collapse under a full-scale Soviet first strike but might cope adequately with the depleted Soviet forces that had survived a U.S. first strike.

And that is what causes the problem. President Reagan, in a little-remembered sentence in his speech of March 23, said, "If paired with offensive systems, [defensive systems] can be viewed as fostering an aggressive policy, and no one wants that." The president was concerned that the Soviets would regard a U.S. decision to supplement — rather than replace — its offensive forces with defenses as an attempt to achieve a first-strike capability. Reagan has subsequently said, "I think that would be the most dangerous thing in the world, for either one of us to be seen as having the capacity for a first strike." But that is exactly how the Soviets are interpreting the SDI program.

If the Soviets do not accept the statements of those who support Star Wars II — if they do not accept that SDI is not part of a first-strike strategy but only a means of strengthening deterrence — how will they respond? It would be foolhardy to dismiss as mere propaganda the Soviets' repeated warnings that a nationwide U.S. strategic defense is highly provocative. Their promise to respond with a large offensive buildup is no empty threat. Each superpower's highest priority has been a nuclear arsenal that can assuredly penetrate to its opponent's vital assets. Such a capability, each side believes, is needed to deter the other side from launching a nuclear attack or using a nuclear advantage for political gain.

The United States has said it would respond to a Soviet strategic defense plan in exactly the same way the Soviets



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have stated they would respond to ours. It is safe to conclude, therefore, from both the U.S. and Soviet statements that any attempt to strengthen deterrence by adding strategic defenses to strategic offensive forces will lead to rapid escalation of the arms race.

To meet the threat of arms escalation, Paul Nitze, Reagan's arms control advisor, articulated a new U.S. "strategic concept" for a cooperative shift to a Star Wars world: "What we have in mind is a jointly managed transition, one in which the United States and the Soviet Union would together phase in new defenses in a controlled manner while continuing to reduce offensive nuclear arms." The president has gone further by proposing to delay the deployment of Star Wars until all offensive ballistic missiles have been destroyed.

Although Nitze has made clear that strategic defensive forces should be deployed only in accordance with the terms of an arms control agreement, no human mind has conceived of how to write such a treaty. Nitze himself has said that the transition to Star Wars would be "tricky."

Why has no one been able to outline the content of such a treaty? Because neither U.S. nor Soviet experts can figure out how to reduce offensive forces, permit defensive deployment, and at the same time, give each side adequate confidence that it can maintain its highest goal: assuring an effective nuclear deterrent against nuclear attack.

So it can be said without qualification: we cannot have both deployment of Star Wars and arms control. That was confirmed at Reykjavik.

In sum, I can see no way by which the U.S. deployment of an antiballistic missile defense will strengthen deterrence.

But assume for a moment that were not the case. Is there an alternative means of achieving Henry Kissinger's goal? He fears the Soviets have now, or will achieve in the future, a first-strike capability. It is that which he is trying to offset or prevent. Can his goal be accomplished at less cost, with greater certainty, and with less risk of fueling the arms race by some means other than the SDI?

The Scowcroft Commission said yes. Its plan to do so is based on the simple approach of reducing the ratio of the number of accurate Soviet warheads to the number of our vulnerable land-based missiles. This could be done through negotiation with the Soviet Union or by replacing our potentially vulnerable fixed-base missiles (Minutemen) with mobile missiles (Midgetmen), or by a combination of the two approaches. Gorbachev has already indicated a willingness to move in this direction if we would by similar moves reduce our threat to his forces.

To summarize, none of these rationales for Star Wars II offers a satisfactory approach to reducing the risk of nuclear war in the decades that lie ahead. And each carries the certainty of high cost and a dangerous escalation of the arms race.

We are left, then, to turn to our final option: a reexamination of the military role of nuclear weapons.

Reexamine the Military Role of Nuclear Weapons

Earlier I stated that no one had ever developed a plan for initiating the use of such weapons with benefit to the West. More and more military and civilian leaders, including Lord Carver and Lord Mountbatten; Admiral Noel A. Gayler, former commander in chief of U.S. ground, air, and sea forces in the Pacific; and Melvin R. Laird, secretary of defense in the Nixon administration, are publicly acknowledging this fact.

If there is a case for NATO retaining its present strategy, that case must rest on the strategy's contribution to the deterrence of Soviet aggression being worth the risk of nuclear war in the event deterrence fails.

But as more and more Western political and military leaders recognize, and as they publicly avow, that the launch of strategic nuclear weapons against the Soviet homeland — or even the use of battlefield nuclear weapons — would bring greater destruction to the West than any conceivable contribution they might make to its defense, there is less and less likelihood that the West would authorize the use of any nuclear weapons except in response to a Soviet nuclear attack. As this diminishing prospect becomes more and more widely perceived — and it will — whatever deterrent value still resides in the West's nuclear strategy will diminish even further. One cannot build a credible deterrent on an incredible action.

Additional factors must be considered. Whether it contributes to deterrence or not, the threat of first use is not without its costs. It is a most contentious policy, leading to divisive debates both within Western Europe and North America; it reduces the West's preparedness for conventional war; and as I have indicated, it greatly increases the risk of nuclear war.

The costs of whatever deterrent value remains in the West's nuclear strategy are substantial. Could not equivalent deterrence be achieved at lesser "cost"? I believe the answer is yes. Compared to the huge risks that we now run by relying on increasingly less credible nuclear threats, recent studies have pointed to ways by which the conventional forces may be strengthened at modest military, political, and economic cost. The West has not done so because there is today no consensus among its military and civilian leaders on the military role of nuclear weapons.

There is, however, a slow but discernible movement toward acceptance of three facts:

- The West's existing plans for initiating the use of nuclear weapons, if implemented, are far more likely to destroy Western Europe, North America, and Japan than to defend them.
- Whatever deterrent value remains in the West's nuclear strategy is eroding rapidly and is purchased at heavy cost.
- The strength, and hence the deterrent capability, of Western conventional forces can be increased substantially within realistic political and financial constraints.

It is on the basis of these facts that I propose we accept that nuclear warheads are not weapons — they have no military use whatsoever except to deter one's opponent from their use — and that we base all our military plans, our defense budgets, our weapons development and deployment programs, and our arms negotiations on that proposition. The ultimate goal should be a state of mutual deterrence at the lowest force levels consistent with stability.

If the Soviet Union and the United States were to agree, in principle, that each side's nuclear force would be no larger than was needed to deter a nuclear attack by the other, how might the size and composition of such a limited force be determined?

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When discussing Gorbachev's proposal for the total elimination of nuclear weapons, I pointed out that a nuclear-free world, while desirable in principle, was infeasible under foreseeable circumstances because the fear of cheating in such an agreement would be very great indeed. Policing an arms agreement that restricted each side to a small number of warheads, however, is quite feasible with present verification technology. The number required for a force sufficiently large to deter cheating would be determined by the number the Soviets could build without detection by NATO. I know of no studies that point to what that number might be, but surely it would not exceed 500. Very possibly it would be far less.

Turning Away from Disaster

I consider, therefore, that the second half century of the nuclear age need not be a repetition of the first. We can — indeed we must — move away from the ad hoc decision-making of the past several decades. It is that process which has led to a world in which the two great power blocs, not yet able to avoid continuing political conflict and potential military confrontation, face each other with nuclear war-fighting strategies and nuclear arsenals capable of destroying civilization several times over.

Through public debate, a debate in which citizens throughout the world — the potential victims of nuclear war — have both the capability and responsibility to participate, the risk of catastrophe can be lowered by establishing long-term objectives that will underlie and shape all aspects of our nuclear programs. That must be our goal.

Most Americans are simply unaware that Western strategy calls for early initiation of the use of nuclear weapons in a conflict with the Soviets. Eighty percent believe the United States would not use such weapons unless the Soviet Union used them first. They would be shocked to learn they are mistaken. And they would be horrified to be told that senior military commanders themselves believe that to carry out our present strategy would lead to destruction of our society.

But those are the facts.

In truth, the Emperor has no clothes. Our present nuclear policy is bankrupt.

President Reagan's intuitive reaction that we must change course — that we must recognize nuclear warheads cannot be used as military weapons — is correct. To continue as in the past would be totally irresponsible.

I previously referred to three crises from my own term as secretary of defense: Soviet pressure in Berlin in 1961; the introduction of missiles into Cuba in 1962; and the Middle East War in 1967. My purpose was to provide a personal perspective on one of the central themes of this article: Things can go wrong. Actions can lead to unintended consequences. Signals can be misread. Technologies can fail. Crises can escalate even if neither side wants war.

Three recent events — the shooting down of Korean Air Lines Flight 007 in 1983, leading to the deaths of 269 civilians; the explosion of the U.S. space shuttle Challenger in January 1986; and the Chernobyl nuclear reactor accident last May — reinforce this point. They serve to remind us all how often we are the victims of misinformation, mistaken judgments, and human fallibility. It is inconceivable to me that in a crisis situation, with all its inevitable pressures, decisions regarding the use of nuclear weapons would be unaffected by such factors.

". . . we must develop a national consensus for a long-term strategy . . . that will reduce the unacceptable risks we now face and begin to restore confidence in the future."

The loss of KAL 007 was a great tragedy. But a similar error in judgment leading to the launch of nuclear weapons would be unparalleled disaster. We must act to avoid such a disaster by making less and less likely the use of these weapons. The course we have been following for nearly half a century has been leading precisely in the opposite direction.

The arms negotiations now under way — and particularly the proposals put forward at Reykjavik for reductions in strategic offensive forces — represent a historic opportunity to change course and to take the first step toward the long-term goals that I have outlined. We can lay the foundation for entering the 21st century with a totally different nuclear strategy, one of mutual security instead of war-fighting; with vastly smaller nuclear forces, no more than 1,000 weapons in place of 50,000; and with a dramatically lower risk that civilization will be destroyed.

The present dangerous and absurd confrontation has evolved through a long series of steps, many of which seemed to be rational in their time. Step-by-step, much of the damage can be undone.

The program I have presented would initiate that process. Whether or not my specific proposals are accepted, we can surely agree on this: we must develop a national consensus for a long-term strategy for the second half century of the nuclear age — a strategy that will reduce the unacceptable risks we now face and begin to restore confidence in the future.

Is not our first duty and obligation to assure, beyond doubt, the survival of our civilization?

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Why the Soviets Are Serious About Arms Control

Michael MccGwire

ARMS CONTROL is a value-laden term, dependent for its meaning not only on a definition of the words but on the viewpoint with which one looks at the process. Most Americans assume that the West has sought the mutual limitation of strategic nuclear weapons while the Soviets have obstructed negotiations. The record of the last two decades argues otherwise.

In truth, Americans have always been ambivalent about the value of arms control. Many believe that it works against U.S. interests. Until the late 1960s, the Soviets shared this ambivalence, believing that world war would inevitably be nuclear and that arms control agreements would impair their ability to survive such a war. Then in 1966 they concluded that nuclear war — and the devastation of Russia — might possibly be avoided. Under that assumption, arms control agreements would not only help avoid war but also promote Soviet military objectives in the event that war could not be avoided. Since then the Soviets have actively sought to limit and reduce strategic nuclear arms. They have even been willing to make unilateral concessions to achieve agreement.

The assumption that the Soviets are eager to seize any chance, however slight, to destroy the United States, coupled with the focus on our own interests and vulnerabilities, has blinded most of us to the tangible evidence of the Soviets' interest in arms control. That evidence is apparent in their strategic missile programs — and the cuts they imposed on those programs. Moreover, the Soviet readiness to negotiate is documented in the memoirs of several U.S. officials. Most recently, in his account of his time as secretary of state, Alexander Haig writes that from the earliest days of the Reagan administration, the Soviets indicated their eagerness to enter into arms control talks on almost any basis.

American misperceptions about Soviet motivations have almost certainly resulted in missed opportunities for meaningful arms control agreements. A continued misreading of Soviet interests and aims could lead the United States to adopt policies whose results are the opposite of what it desires. The Strategic Defense Initiative is a case in point. This article explains the logic of the Soviet policy on arms control and sets out concrete evidence of the changed approach. It then examines the roots of U.S. arms control policy and the reasons for our misperceptions. Finally it considers what this combination portends for arms control in the wake of the Reagan-Gorbachev meeting in Reykjavik last October.

The Possibility of Avoiding Devastation

Since the 1950s Soviet doctrine had held that a world war — a war they absolutely want to avoid but cannot afford to lose — would inevitably be nuclear and just as inevitably entail massive strikes on Russia. In such a fight to the finish, where defeat would be synonymous with extinction, the twin Soviet objectives were to

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preserve the socialist system and destroy the capitalist one. The latter objective required nuclear attacks on the United States and its allies, and to the extent these attacks could disarm the West's ability to retaliate, they would help preserve the socialist system. Soviet strategy was therefore predicated on successful nuclear preemption.

The Soviet belief that a world war would inevitably be nuclear reflected the declared Western policy of relying on "massive retaliation" and NATO's stated readiness to resort immediately to nuclear weapons in the event of war in Europe, policies that went back to the mid-1950s. The West began to move away from those policies in 1961 when the Kennedy administration introduced the concept of "flexible response," proposing to check a Soviet offensive in Europe for several days using conventional forces only. Initially the Soviets misread this concept as an attempt to improve NATO's ability to wage nuclear war, in part because its introduction coincided with the deployment of new U.S. nuclear weapons in Europe. By 1964, however, the Soviets were coming to recognize that flexible response implied that a war in Europe might start with a conventional phase, although they continued to assume that nuclear escalation was inevitable.

It was only in the second half of 1966, probably as the result of a reevaluation following France's withdrawal from NATO, that the Soviets appear to have reached two conclusions. One was that a war in Europe would not inevitably lead to massive strikes on Russia, except in retaliation for an attack on North America. The other was that the size and diversity of the U.S. strategic arsenal meant that a preemptive strike on the United States would do little to limit the devastation of Russia. During this period the strategic opportunity presented by the NATO doctrine of "flexible response" became clear to the Soviets. If, during this initial conventional phase of a war in Europe, the Soviets could neutralize NATO's theater nuclear forces, they could remove the first rung of escalation. If they could knock NATO out of the war using nonnuclear forces, the question of intercontinental escalation might become moot.

These new considerations led the Soviets to conclude in December 1966 that a world war would not necessarily be nuclear and, even if it were, it would not necessarily include massive strikes on Russia. Under this new doctrine, it became logically possible for the Soviets to adopt the objective of avoiding the nuclear devastation of Russia.

As a corollary, the Soviets had to forgo the wartime objective of destroying the capitalist system because that could be achieved only by launching nuclear strikes on the United States, which would invite retaliatory attacks on Russia. Instead, the Soviets had to adopt a lesser objective, such as gravely weakening the capitalist system, and accept that North America would be left undamaged. Leaving the United States untouched meant that the U.S. military-industrial base would remain intact, and it therefore became essential to deny America a bridgehead in Europe from which to mount an attack on Russia.

The strategic requirements were clear. There remained the problem of how to defeat NATO in Europe in the event of war without precipitating a nuclear attack on Russia. In 1967–68 the Soviets set out to restructure their forces to provide the capability, using conventional means only, to disable NATO's nuclear delivery systems and to mount a blitzkrieg offensive into Western Europe. Even if the Soviets were not fully successful, NATO's nuclear capability would be greatly reduced and the escalatory momentum lessened. This new Soviet capability was largely in place by the second half of the 1970s, when it was supplemented by a political campaign to persuade NATO to adopt a policy of "no first use" of nuclear weapons in the theater and to persuade the United States that the resort to nuclear weapons in Europe would inevitably lead to strikes on North America.

The Soviets also had to deal with the danger that the United States, when faced by the impending defeat of NATO in Europe, would launch a full-scale nuclear strike on Russia. No defense against such an attack existed. The only means of preventing it was deterrence: the threat of nuclear retaliation on North America.

The need to reverse Soviet policy on preemption made it harder for the Soviets to ensure the credibility of this deterrent. Preemption had been a cornerstone of the 1960s strategy. The new 1970s hierarchy of objectives required the Soviets to forgo any suggestion of first use that might precipitate a NATO decision to resort to nuclear weapons or a U.S. decision to strike at Russia. The evidence now suggests that the Soviets will wait to launch their strategic forces until they have warning of a U.S. attack. In other words, they are braced for NATO and the United States to launch first in the course of a war.

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Identifying Soviet Policy: The Underlying Analysis . . .

Given the Soviet Union's obsession with secrecy, how is it possible to describe the evolution and present aims of Soviet arms control policy with such confidence? Three factors are important. First, the Marxist belief that regularities exist in all aspects of human endeavor places a premium on goal setting and achievement. Second, the more tightly planned an economic system, the larger the reverberations when policy changes. Third, the nature of the Soviet state requires that ideology and doctrine be publicly articulated.

The strong influences these factors have on national security policy allows the use of four analytical tools that would be of little help in interpreting U.S. policy. The most extensive tool is "objectives analysis," which exploits two kinds of evidence, both fairly readily available. The structure, disposition, and deployment of Soviet forces provide concrete evidence, as do Soviet weapon procurement programs and operational concepts. At the other end of the spectrum is the evidence from authoritative doctrinal statements about the likely nature of a future war and the methods of waging it, which can be fleshed out by the professional debates in the military press. The link that joins these two bodies of evidence and makes sense of their relationship is the hierarchy of objectives. Doctrine determines objectives, which determine missions, which define requirements, which become manifest as weapons systems and operational behavior.

The Soviet strategic hierarchy of objectives can be reconstructed using a combination of inductive and deductive analysis. The process develops a series of hypotheses whose proof lies in the details of weapons programs, military exercises, and policy pronouncements. The emerging hierarchy, itself a complex hypothesis, allows the analyst to impose coherence on this mass of evidence and to discover new evidence.

A second analytical tool is the "decision period." Soviet planning works on a five-year cycle, but unusual circumstances may require major shifts in policy outside the established cycle. That decision process can be pictured as a wave form. The rear slope of the wave represents the period when perceptions of the need for change build up to the crest of a top-level agreement-in-principle. The front slope of the wave —the decision period—represents the period of implementing decisions that stem from this acceptance of the need for change.

Depending on its nature, evidence of these implementing decisions emerges during the following 10 years or more and will sometimes indicate the substance of the new policy. But the "why" of a policy is as important as the "what," and it is always necessary to date the decision period, using estimates of lead time. One can then move to the rear slope of the wave, seeking in the circumstances of that period the likely causes of the change in policy. Last, one identifies as precisely as possible the substance of the

Less Is Better

It took the Soviets the best part of 10 years to restructure their ground and air forces sufficiently to allow them to adopt the 1970s hierarchy of objectives; the restructuring of naval forces is taking even longer. During this transition they could not afford to cut back their forces in central Europe, which was why they did not begin to negotiate seriously on mutual and balanced force reductions until 1979. The converse pertained in the case of strategic systems. The logic of the 1970s objectives required the curtailment of existing programs and active negotiations to limit strategic weapons.

While arms control agreements can serve important economic purposes, at the core of Soviet arms control policy are two objectives: the political objective of avoiding world war; and the military objective, should war prove inescapable, of not losing. Before 1967–68 the Soviet Union had a limited interest in arms control. Because it lagged so far behind the United States in most aspects of military capability, its primary aim was to draw level and, if possible, to move ahead, a goal that an arms control agreement might well prevent. Nor was there strong evidence that arms control agreements made war less likely.

During 1967–68 the Soviets came to realize that constructive negotiations on limiting strategic arms could contribute significantly to improved Soviet-American relations and hence reduce the likelihood of war. Meanwhile the logic of the 1970s hierarchy of military objectives argued strongly for limits on the size of the superpowers' nuclear arsenals. Combining the two levels of objectives changed the cost-benefit calculus of arms control from negative to positive. More was no longer better.

Offensive Strategic Systems

Under the 1970s hierarchy, the primary mission of Soviet intercontinental ballistic missiles (ICBMs) was no longer strategic preemption but wartime deterrence — to deter the United States from striking at Russia even when faced with the defeat of U.S. forces in Europe. The effectiveness of this deterrence did not depend on the size of the ICBM force. Indeed, the Soviets could reason that if a U.S. president was not deterred from striking at Russia by a Soviet threat to destroy 5 or 10 of America's largest cities, then he was unlikely to be stopped by a threat to 50 or 100 cities. Should the Soviet wartime deterrent prove ineffective, however, the smaller the size of the U.S. intercontinental missile inventory, the less extensive the nuclear devastation of Russia. Under this logic, less was better. And the only way to reduce the size of the U.S. nuclear inventory was through mutual agreement on arms limitations.

This downward pressure on Soviet ICBM levels was, however, constrained by the need to match the U.S.

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change. One can then assess how the change would have affected the existing hierarchy of objectives and what the implications are for Soviet behavior.

The primary function of the two other tools, "procurement analysis" and "hardware analysis," is to generate evidence in support of the first two approaches. Procurement analysis requires the reconstruction of various weapon programs over time. Hardware analysis focuses on the structure and employment of Soviet forces and the characteristics of their weapons and equipment. From this evidence one can infer a great deal about the evolving missions of these forces and the operational requirements that determined the original design. These missions and requirements constitute the lower levels of the objectives hierarchy.

There is firm evidence of seven significant decision periods affecting Soviet defense policy in the 35 years following World War II. The sixth of these, 1967–68, resulted from a watershed in Soviet thinking about the likely nature of a world war. The restructuring of Soviet ground and air forces facing NATO that became apparent in the mid-1970s could be dated back to decisions taken in the late 1960s, and it was widely assumed that this restructuring was in response to NATO's formal adoption of "flexible response" in 1967. This explanation could not, however, explain the anomalies in Soviet naval developments that began to emerge in the early 1970s.

In 1983 I was engaged on a general analysis of Soviet military requirements and was therefore led to examine the textual material in the 1965–67 period. This uncovered the shift away from the established doctrine that a world war would inevitably be nuclear to the new doctrine that it would not necessarily escalate to a nuclear exchange. This textual analysis also showed that the decision must have been given official sanction toward the end of 1966, probably at the Central Committee Plenum in December.

The new hierarchy of objectives dictated by this shift in doctrine accounts for the course of military developments in the 1970s, including changes in the pattern of naval construction and apparent anomalies in submarine design and building. It also explains apparent contradictions in the Soviet approach to arms control: the acceptance of the ABM treaty, the stonewalling at the European force reduction talks, and the tough negotiations at the strategic arms limitation talks.

The Soviet shift did not go entirely unnoticed. By the early 1970s a few Western analysts had begun to sense that something was afoot. Yet even if the change in doctrine had been widely recognized at that time, it was not intuitively obvious that the relatively subtle alterations in wording regarding the nature of a world war would have such far-reaching consequences. Those only become clear when the effects of the new doctrine on the hierarchy of strategic objectives are analyzed.

inventory. An equivalent Soviet capability provided the leverage required to negotiate reductions in U.S. strategic forces and at the same time denied Washington the advantage of conducting its foreign policy "from a position of strength." And despite their emerging doctrine that no one can win a nuclear war, the Soviets were not prepared to allow the United States an advantage in weapons that might allow it to dictate the outcome, should such a war occur.

Defensive Systems

A comparable change took place in the calculus of advantage for defensive systems. Under the 1960s hierarchy, defensive weapons would help preserve the socialist system in the event of intercontinental nuclear exchange. Furthermore, military doctrine stressed the interrelatedness of offense and defense.

The 1970s objective of avoiding the nuclear devastation of Russia introduced a new consideration. If nuclear attacks on Russia could not be physically prevented, only deterred, and if the credibility of deterrence depended on the certainty that Soviet ICBMs, if launched, would strike home on North America, then an effective U.S. anti-ballistic missile (ABM) system would threaten that credibility. Assuming that it might not be possible to launch Soviet strategic forces on warning, such a U.S. defense became a live possibility because a Soviet retaliatory strike would only be a fraction of the original ICBM force. It was now more important to halt the development of U.S. ballistic missile defense systems than to deploy a marginally effective Soviet ABM system.

Evidence of the Change

The Soviets pressed for the maximum limitations on ABM systems from the start of the strategic arms limitations talks (SALT) in November 1969. They were even willing to consider a complete ban, which would have involved dismantling the existing ABM sites around Moscow. And when difficulties emerged in reaching agreement on limits for offensive weapons, the Soviets sought to defer discussion of those weapons until after the conclusion of an ABM treaty.

This volte-face in Soviet policy was evidence of the shift in wartime objectives (see box, pp. 14–15). It was accompanied by equally significant changes in Soviet modernization plans for strategic missiles. In the first half of 1970, when the first strategic arms limitation talks had been in progress for a few months, the Soviets abandoned the construction of more than 70 newly started ICBM silos, including 18 for the "heavy" SS-9 missile that was of particular concern to the United States. Further evidence came with the signing of SALT II in 1979, when the Soviets

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. . . And the Evidence of Soviet ICBM Programs

Dramatic cuts in Soviet missile programs provide persuasive evidence of the shift in the Soviet approach to arms control. Procurement analysis demonstrates that by 1970 the Soviets had already decided to cut their ICBM programs. The analysis involves identifying changes in plan and inferring what had been intended at each decision period, even if production was never achieved.

The Soviets have embarked on at least 15 separate intercontinental ballistic missile programs. These are most easily viewed as five generations of missiles, each successive generation embodying technical improvements in accuracy, payload, and other characteristics. The first generation was so crude it never went into serial production. The initial buildup of the Soviet ICBM force was thus achieved with second and third generation missiles. The fourth generation would upgrade this force by replacing the entire inventory on a 10-year cycle. This force would be replaced by a fifth generation, if necessary.

Deployment of the second generation began in 1961, with the third generation due to enter service in 1966. The original plan would likely have led to a force of 1,200 ICBMs by the end of 1970, with production in 1966–70 running at 144 missiles a year. This force would have been capable of devastating North America. But the U.S. decision in the first half of 1961 to deploy a large but unspecified number of Minuteman ICBMs at a rate of 250 to 300 a year threw the Soviet plan off track.

The Soviet response to this new challenge from the United States was complex. It is sufficient to say that by 1965 Soviet production capacity had been increased to enable the deployment of 336 third generation ICBMs a year. The buildup was achieved at the expense of the production of intermediate range missiles that had been intended to cover "regional" targets in Europe and Asia. Allowing for various delays, this revised plan would have resulted in a Soviet force of about 1,600 ICBMs at the end of 1970 and over 3,000 by the end of 1975. However, when the Minuteman deployment was completed at 1,000 missiles, the Soviets reassigned more than half their production capacity to cover regional targets.

The Effects of SALT

The abrupt curtailment of third generation ICBM programs in the spring of 1970 was clear evidence of a shift in policy (see figure 1). By then the logic of the new hierarchy of objectives had been accepted, the SALT program had taken hold, and decisions regarding the ninth Five Year Plan needed to be made. This sudden abandonment of more than 70 launch silos resulted in a force of only 1,018 third generation ICBMs targeted on North America, matching the U.S. force of 1,000 Minuteman missiles in numbers but not in quality. The Soviets also had 360 third generation missiles that had been adapted to cover regional targets, plus 209 already obsolete second generation systems. This disparate collection yielded the nominal total of 1,587 ICBMS that the West counted when comparing forces.

The Soviets began to match the Minuteman in quality only in 1975, when they started to replace third generation missiles with fourth generation ICBMs at the rate of 144 a year. This pace was slower than the 336 planned in 1965, but before the program could run its 10-year course, the arms control process again intervened. At SALT II, which they signed in June 1979, the Soviets accepted a ceiling of 820 MIRVed missiles, and all Soviet fourth generation missiles were counted as MIRVed. The Soviets thus had to abort the conversion of 100 launch silos to hold fourth generation missiles and forgo the replacement at this stage of some 550 third generation missiles (see figure 2).

The Significance of START

The Soviets' willingness to reduce their inventory even further was evident at the START negotiations in 1982–83, when they proposed a reduction of 450 in the SALT II ceiling on strategic nuclear delivery vehicles (SNDV). The proposal would also have reduced the allowable number of MIRVed ICBMs from 820 to 680, requiring the Soviets to scrap 138 fourth generation missiles but leaving U.S. plans to deploy 100 MX missiles unaffected. When the Soviet START proposal is superimposed on the details of the existing missile inventory, one can infer the structure of the strategic force then envisaged. The 1800 SNDVs would be made up of 1,000 ICBMs, 680 submarine-launched ballistic missiles (SLBMs), and the 120 missile-armed bombers already allowed by SALT II. The 1,000 ICBMs would comprise 680 MIRVed missiles and 320 with single warheads. The 680 SLBMs would consist of 280 single warhead missiles (the SS-N-8) and 400 MIRVed missiles, 288 of which were already deployed (the SS-N-18) and the remainder of which would go to sea aboard the Typhoon and Delta IV submarines.

The 320 single warhead ICBMs would consist of fifth generation SS-25s, a mobile missile that is the linear successor of the unsuccessful SS-13. It is at least possible that the Soviets would have been content to make do with the fourth generation SS-18 and SS-19 missiles as the MIRVed component of the ICBM force, but by 1982 they had decided that they had no choice but to go ahead with fifth generation replacements. The 1,080 MIRVed ballistic missiles constitute the primary wartime deterrent and, should deterrence fail, would carry out the initial Soviet intercontinental strikes. The 600 single warhead missiles are intended mainly for "war fighting" following an intercontinental exchange, and they also constitute the strategic reserve.

There is no reason to suppose that this force structure represents some "minimum requirement" that would prevent further cuts in Soviet missile inventories. The structure seems rather to reflect the objective of maximizing Soviet strategic capability within constraints imposed by the arms control process and the economy. The Soviet proposal at START can be viewed as a serious, if unsuccessful, attempt to bring the Soviet and U.S. forces closer into line, facilitating mutual reductions in the future.

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Figure 1:
Third Generation ICBMs, Planned and Actual Deployment

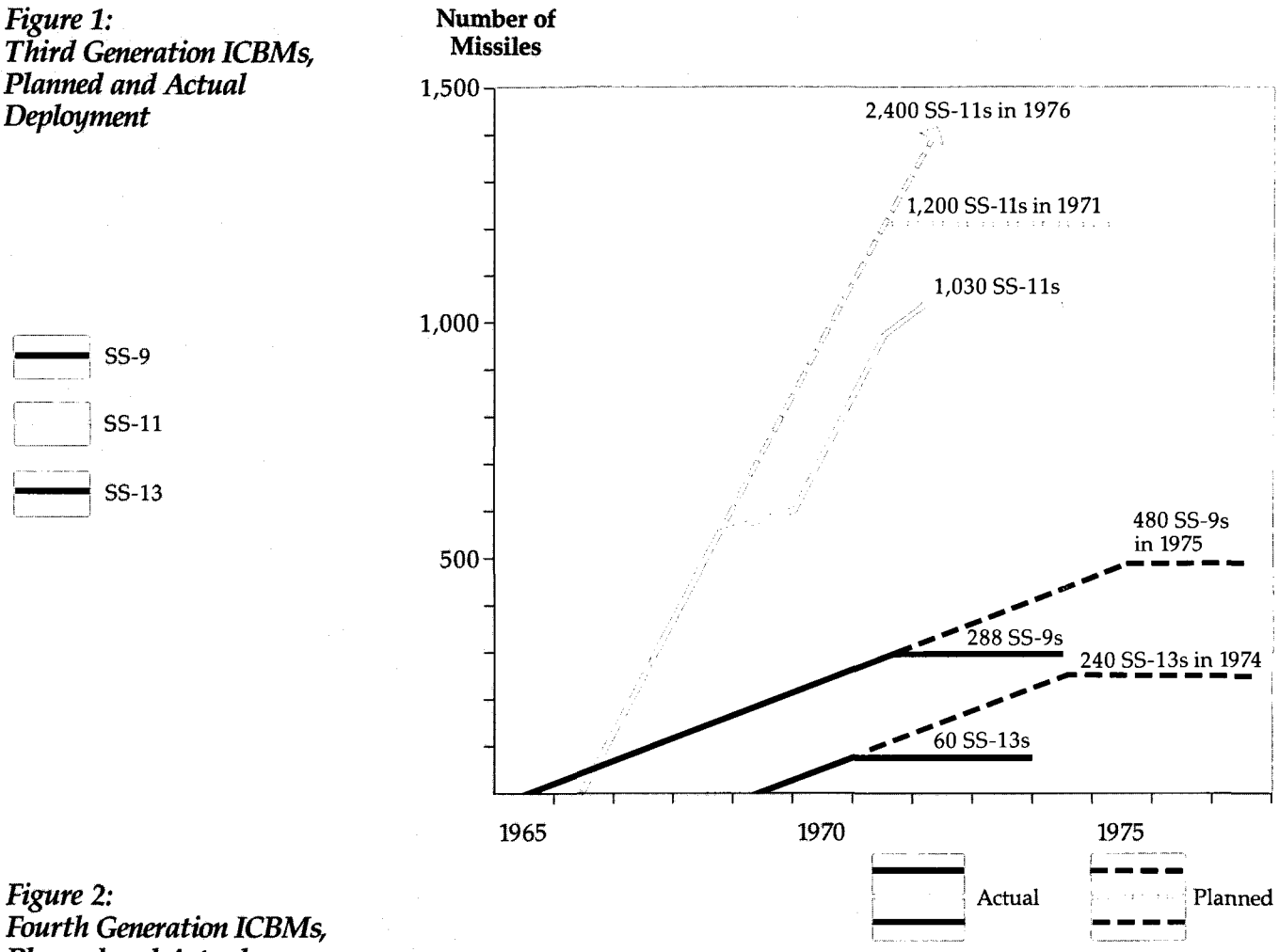
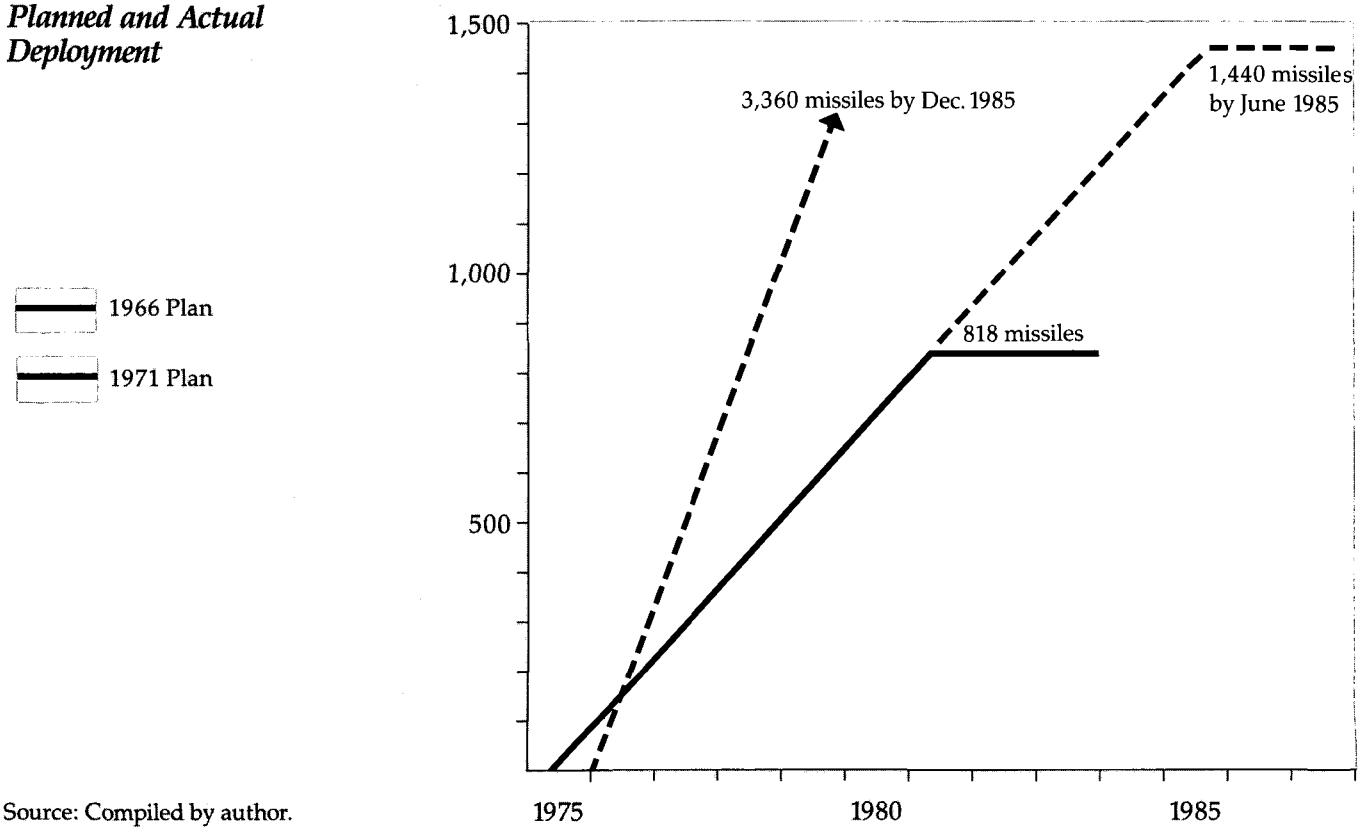


Figure 2:
Fourth Generation ICBMs, Planned and Actual Deployment



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aborted the conversion of about 100 ICBM silos from third to fourth generation systems. Underlying both these outward indications were even more fundamental changes in the Soviet ICBM program.

The United States made no comparable concessions. Neither SALT agreement had any effect on existing U.S. plans for modernizing its strategic forces. SALT I did not touch U.S. plans to MIRV Minuteman, that is, to fit the missile with multiple, independently targeted warheads. Weapons limits in SALT II did not include ground- and sea-launched cruise missiles. The SALT weapons limits did not really bite until late 1985, when the U.S. Navy had to dismantle a 20-year-old, 16-tube Poseidon submarine to bring a 24-tube Trident on line.

Soviet interest in arms control as an ongoing process leading to weapons limitation was again demonstrated at the strategic arms reduction talks (START) in 1982–83, when Soviet negotiators were presented with a proposal that Haig later described as "non-negotiable" and "two-faced." The package would have left U.S. plans unaffected but required the Soviets to reduce the number of existing warheads by 60 percent and dismantle about 75 percent of their modern MIRVed missiles. Instead of breaking off the negotiations as pointless, the Soviets responded by proposing further reductions in the SALT II limits. These new ceilings would have required them to cut their MIRVed ICBM force by 138 launchers but would have accommodated the additional 100 MX mobile launchers projected in the 1982 U.S. defense budget as well as the 18 Trident submarines allowed under SALT II.

". . . there is a world of difference between the theory of arms control as developed in the United States and arms control policy as pursued by successive U.S. administrations."

American Ambivalence

Given the striking evidence of Soviet interest in arms control, how does one account for the widespread perception that the Soviet Union has to be pressured into negotiations? Part of the explanation lies with the Soviets themselves. They see arms control as an incremental process and, until recently, have responded negatively to radical new initiatives. Once embarked on negotiations, the Soviets aggressively pursue relative advantage, seeking to cap Western capabilities and fence off dangerous new developments whenever possible, while protecting their own programs and possibilities for future development. At the same time, their fear of disclosing key military objectives accentuates their natural secretiveness.

The misreading is also a function of U.S. domestic politics. To gain support for arms control from the conservative right, successive administrations have funded new weapons programs, explaining that they were necessary to bring the Soviets to the negotiating table. But the main reason for misperception lies in our mistaken assumption that Soviet arms control policy continues to mirror the ambivalence of the U.S. policy.

The United States acquired strategic superiority in World War II and has been understandably reluctant to give it up. U.S. policymakers have used arms control negotiations to limit and, if possible, reduce Soviet inventories in areas where the Soviets were catching up or moving ahead. U.S. negotiators have rejected limits in areas where asymmetries in force structure or advanced technology give the United States an edge. The Strategic Defense Initiative (SDI) is the latest variation on this theme.

During the 1960s and 1970s the emerging concepts of parity, equivalence, and sufficiency ran into tenacious resistance in the United States. In the 1980s the Reagan administration sought explicitly to restore some measure of superiority, while denigrating existing arms control agreements. The SDI reflects this logic. Defense Secretary Caspar W. Weinberger explained to the Senate Armed Services Committee on February 1, 1984, that the SDI offered the prospect of returning to the situation of the immediate post-World War II years when the United States was "the only nation with nuclear weapons and did not threaten others with [them]."

However, the difference in the two sides' approaches extends beyond the level of their interest in arms control to the theoretical underpinnings of the term. For the Soviet Union arms control implies limiting and reducing the size of nuclear arsenals. For the United States it has more to do with crisis stability, a concept that derives from nuclear deterrence theory and its offshoot, reassurance theory. Deterrence theory, which emerged in the early 1950s and reflected the lessons of Munich and World War II, held that Soviet aggression in Europe could only be prevented by the threat of dire punishment and that the credibility of that deterrence depended on the certainty of the U.S. response. The means of retaliation, therefore, had to be held totally secure, a requirement that gave full rein to a new form of worst-case analysis as imaginative theorists sought to discover possible chinks in the armor of assured response.

In the second half of the 1950s, as the Soviets began to acquire the capability to strike at North America, other theorists focused on a danger that stemmed from the nature

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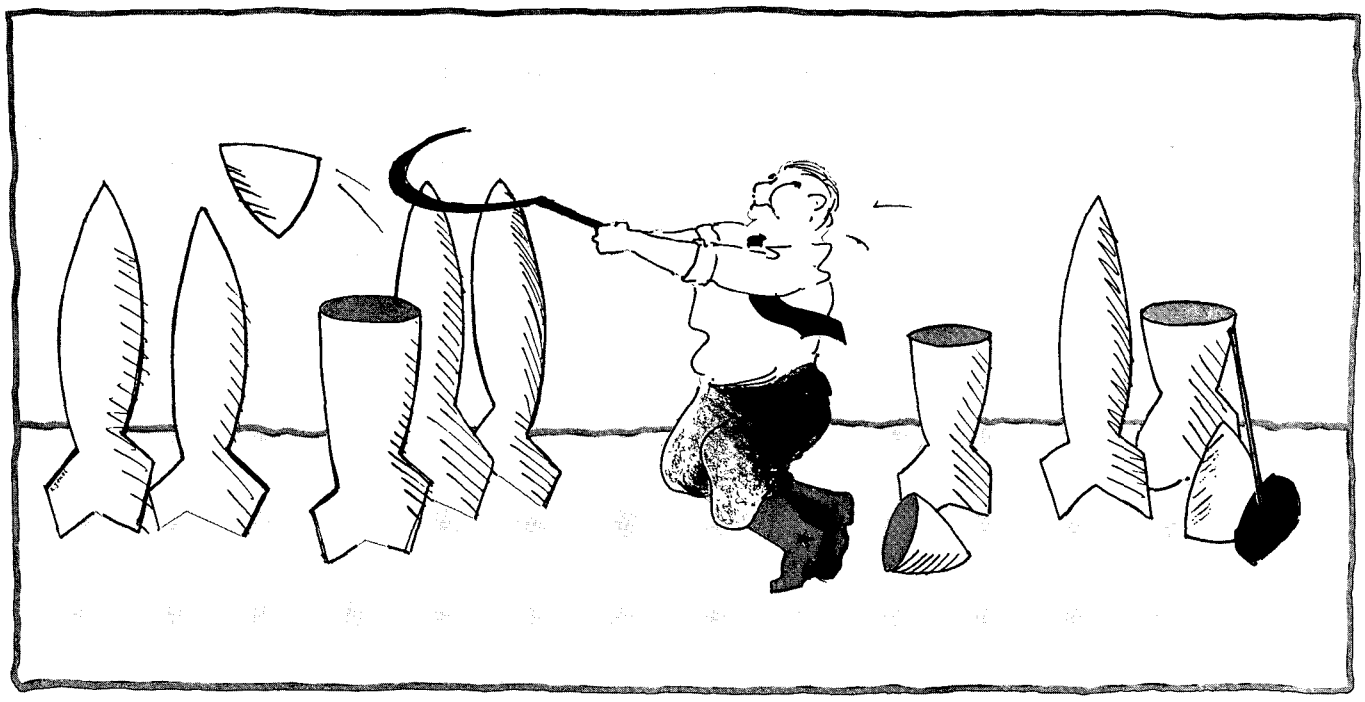

of nuclear weapons and did not depend on either side having aggressive intentions. In a confrontational situation, the advantage of disarming the other side by getting in the first blow was so great that a prudent national leader might be prompted to launch a nuclear strike on the mere suspicion that the other side was contemplating war. This pressure to preempt in a crisis introduced a new concern for the "stability" of deterrence. It became necessary to find ways of reassuring the Soviets in a crisis that the United States would not initiate preemptive war.

U.S. arms control theory had its intellectual origins in this recognition of the need for mutual reassurance, which was to be achieved by both sides having an assured "second strike" (or more properly, strike second) capability. Deterrence theory requires that the United States be able to launch its whole force under attack. Reassurance theory is more demanding and requires that each side should have enough weapons to survive a first strike and still be able to devastate the opponent's homeland. The theory, which underlies the concept of mutual assured destruction, also assumes that both sides would avoid weapon systems that might deprive the other of such a capability. Failing that, reassurance theory becomes a recipe for arms racing, as each side seeks to ensure that it can absorb a first strike and still retaliate.

In any case, there is a world of difference between the theory of arms control as developed in the United States and arms control policy as pursued by successive U.S. administrations. American policy is a shifting amalgam of the viewpoints of the reassurers, the deterrers, and those who seek to retain military superiority. The reassurers' requirement to be able to ride out an attack links the two opponents in an upwards spiral, and concern for the credibility of deterrence provides arguments for more, different, or better offensive weapons. Both theories can be manipulated to require de facto U.S. superiority. Nor does an assured response have to depend on arms control; it can be pursued unilaterally through new weapons programs and innovative basing modes.

The American ambivalence toward arms control explains why the United States could more than triple its warheads in the years immediately surrounding the signing of SALT I. Between 1970 and 1975, the number of U.S. warheads shot up from 1,775 to 6,800. During the same period, Soviet warheads increased from 1,700 to 2,700. It explains why SALT II allowed the United States to add 3,360 air-launched cruise missiles to the strategic inventory (trading in gravity bombs and short-range standoff weapons), and why the United States refused to accept any limits on the ground- and sea-launched versions of these strategic systems. By 1979 the United States had authorized production of both versions and, besides the 464 cruise missiles already earmarked for Europe, it plans to deploy about 750 nuclear cruise missiles aboard some 80 surface ships and about 100 attack submarines. The Soviets are following suit.

There is also a fundamental difference in how the two sides view the danger of war. Deterrence theory fosters the idea that war can only come about through a premeditated Soviet attack or some other initiative that the West must counter. Reassurance theory worries about the pressure to preempt in a crisis. Both theories focus on the danger of sudden attack, and both seek to prevent war by the threat of certain punishment. The Soviets are not primarily concerned about a bolt from the blue, and by 1959 they had largely discounted the possibility of a premeditated U.S. attack. They also see little relevance in the "pressure to preempt" that underlies the American concern for crisis stability, having themselves discarded as counterproductive the concept of intercontinental nuclear preemption. The Soviets believe war is most likely to arise from a chain of events that cannot be deterred by some threat of punishment. The first requirement is, therefore, to reduce the causes of East-West tension, amongst which arms racing ranks high in Soviet, if not American, eyes.

Illustration by Regina Jones

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Beyond Reykjavik

No one should have been surprised that the negotiations in Reykjavik last October foundered on the SDI. The Soviets immediately objected to placing weapons in space when Reagan first broached the idea in 1983. They reasserted those objections at the Geneva summit in 1985, and they implicitly conditioned a summit in Washington on progress in preventing the extension of the arms race into space.

The Soviets repeatedly noted the lack of such progress in the months preceding Reykjavik, but the Reagan administration dismissed these objections as a negotiating ploy. Officials acknowledged that the SDI would cause the Soviets the expense of matching or outflanking a U.S. ballistic missile defense system, but were unable to grasp the more fundamental nature of the Soviet objections.

The SDI requires the United States to scuttle the only strategic arms limitation treaty it has ratified. Abrogation of the ABM treaty will reverse the arms control process, depriving the Soviets of their only means of effecting reductions in the U.S. nuclear arsenal, and will open up a new arena for arms racing. The SDI also makes conflict in space almost inevitable. The Soviet Union cannot afford to let the United States build a space-based weapon system that could neutralize the Soviets' wartime deterrent and spell the demise of the Soviet state. A multilayered missile defense, even if less than perfect, would have some chance of absorbing a Soviet retaliatory attack in the wake of a U.S. disarming strike. If the United States refuses to be bound by treaties banning space weapons, the Soviets will have to consider whether to prevent the assembly of the SDI components in space (see box, p. 19).

"The Soviets must also be prepared to defeat a space-based defense system by saturating it with more warheads than it can handle."

The Soviets must also be prepared to defeat a space-based defense system by saturating it with more warheads than it can handle. They cannot therefore afford to reduce their ICBM inventory unless the ABM treaty is strengthened to exclude permissive interpretations and unless they are convinced that the United States will abide by it. But even if these major obstacles were removed, the two sides still have quite different interests in limiting strategic nuclear weapons.

The primary mission of the Soviet force is to deter a U.S. nuclear attack on Russia in wartime. If America has no strategic nuclear weapons, Russia needs none. If nuclear weapons remain, the smaller the two sides' arsenals, the better for the Soviets. U.S. nuclear forces are intended to deter all forms of Soviet aggression, a requirement that would persist in the absence of Soviet nuclear weapons. Furthermore, even moderates in the United States consider that some 6,000 warheads are necessary to ensure that the Soviet Union is "deterred" in all circumstances.

The difference in requirements extends to nuclear delivery systems. This fact was demonstrated in the wake of Reykjavik, when the United States wanted to limit the proposed ban on nuclear weapons to ballistic missiles, whereas the Soviets were prepared to accept a ban across the board. The United States has always had a technological lead in bombers and long-range cruise missiles, as well as in defense against them, which is helped by America's geographical isolation. It refused to allow bombers to be counted in SALT I and excluded ground- and sea-launched cruise missiles from SALT II. The Soviets, therefore, cannot afford to give away their ICBMs — one of the few negotiating levers they retain — without securing concessions in bombers and cruise missiles, where the United States has a significant advantage.

Theater systems are a separate issue. The Soviets believe that the elimination of nuclear weapons in Europe is to their operational advantage and will also reduce the likelihood that conflict will escalate to nuclear strikes on Russia. However, they have had to balance their interest in banning theater systems against the possibility that the prospect of such agreement can be used as leverage to bring the United States to the table on the SDI. I suspect that the Soviets' overall negotiating position could be improved by concluding an agreement on theater nuclear forces, even if there is no progress on the SDI. With its recent proposal to negotiate separately on theater forces, it may be that Moscow now sees the situation the same way.

The ironies surrounding the present impasse are inescapable. Since 1969 the Soviets have sought to reduce the size of nuclear arsenals but have been unwilling to divulge that aim lest it weaken their negotiating position. They have been willing to make unequal concessions, but these have not been recognized as such by a United States preoccupied with its own vulnerabilities. If we had pressed ahead within the negotiating framework agreed upon at the Vladivostok summit in 1974, we might have halted the Soviet buildup at a significantly lower level and then gone on to achieve reductions in strategic forces. Instead arms control became hostage to U.S. domestic politics. Successive administrations have embarked on new weapons systems as a way of securing the political acceptance of those agreements that have been negotiated. The Reagan admin-

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Star Wars . . . The Missing Questions

The quality of the debate on the Strategic Defense Initiative is pitiful. Support for the concept has become a test of loyalty to President Reagan and, in the minds of many Americans, to the United States itself. America's allies remain reluctant to line up with the Soviets in challenging the president's dream.

The issue before us is not one of loyalty. Nor is it a matter of freedom versus oppression or of good versus evil. The issue is whether placing weapons in space is likely to increase the possibility of world conflict. To oppose the SDI is not a statement on the comparative merits of capitalism versus communism. It is a judgment on the global implications of an American policy that is being pursued for largely domestic purposes.

Reflecting the biases of U.S. defense analysis, the SDI debate focuses on the likely cost and its technological feasibility. The straitjacket of deterrence theory ensures that discussion of the implications of the SDI is limited to its effects on deterrence and crisis stability.

Two prior questions are missing altogether. First, do we really need the SDI? Supposing a leakproof defense were possible and would not be destabilizing, is our enmity with Russia of a magnitude to make such a defensive shield necessary? Our failure to address this question seriously means that an affirmative answer wins by default. The other missing question concerns the long-term consequences of placing weapons in space. The SDI sets us inexorably on the path of confrontation and conflict in space and effectively removes the possibility for cooperative peaceful development. Is that really what we want?

Weaponizing space will be as profound in its consequences as developing the atom bomb. But in 1945 we faced a fait accompli. We had already gone over the waterfall that divided the nuclear from the nonnuclear military world. Today we are only now approaching the next great waterfall, which divides earthbound weapons from space-based strike systems. In 1945-46 we could not see what was at stake when we let slip the fleeting opportunity to halt the production of atomic bombs. Today the consequences are all too clear, with 20,000 warheads on each side and the slow but steady proliferation of a nuclear capability among lesser powers. We can also see how MIRVed missiles, which were meant to improve American security, actually increased our insecurities. Belatedly we recognize that an agreement to ban this theoretically and technologically attractive development would have better served our interests.

In the 1950s we turned to nuclear weapons to meet the newly perceived threat of Soviet military aggression. That deterrent remains in place, and there is no new threat to prompt a new response. Meanwhile the original threat is generally considered to have been exaggerated. In the early 1940s we were caught up in a desperate war, which swept us over the atomic divide with no debate and scant reflection. There is no such current sweeping us along today.

No strategic imperative impels us to place weapons in space, and we are well positioned to avoid going over the next waterfall. A negotiating structure is already in place, the Soviets are eager to reach agreement, and verification poses relatively few problems. We therefore have the unusual option of remaining on this reach of the river. But we are being lured forward by the sirens' songs of technological challenge and total security.

As a nation we may be entitled to our fantasies. But we are not entitled to imperil the future of the human race in pursuit of them. We cannot foresee the full consequences of extending the arms race into space. But there can be no doubt that an arms race in space will be immeasurably more dangerous than the earthbound one that has taken us 30 years to bring in check.

istration, skeptical of any kind of arms control, now offers the implausible argument that the SDI will force the Soviets to cut back on their strategic missile force.

A second irony is that it is left to the Soviet Union, the "evil empire" berated by the United States for its aggressive behavior, to draw attention to the portentous consequences of putting weapons in space. The Soviets believe that such a step is at least comparable to the introduction of atomic weapons in 1945. There is some discussion in the United States of the SDI's implications for crisis stability but no significant debate on the advisability of opening the Pandora's box of "weaponizing" space.

A third irony is that a president untutored in Western arms control theory, leading a fractious administration that is largely unsympathetic to arms control and holds outdated assumptions about Soviet doctrine, should have engendered a situation that is peculiarly favorable to reaching an agreement on major reductions in nuclear weapons. This turn of events has occurred partly because the Soviets are prepared to make major concessions to keep weapons out of space and partly because Reagan is still uniquely qualified to deliver the Senate votes to ratify such a revolutionary treaty. But it is also attributable to a new readiness in the United States to question the theories of deterrence and reassurance.

Having been ridiculed from the right for basing America's defense on the threat of mutual suicide and challenged from the left on the morality of threatening nuclear devastation, the arms control community must now assimilate the proposals for sweeping reductions in nuclear weapons that were agreed on in principle at Reykjavik, proposals that evoked widespread popular support. There may now be a new willingness to recognize that the West's oversophisticated theory of arms control has resulted in ridiculously high levels of armaments on both sides and to examine the merits of a less complicated approach — one that assumes that deterrence can work at a low level of threat and that concentrates on reducing the size of the two sides' nuclear arsenals. That this also happens to be the Soviet approach is no reason to reject it.

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Getting Back on Track: An Economic Overview

George L. Perry

THE YEAR 1987 shapes up as one of continued economic growth. The United States will avoid a tumble into recession and add a fifth year to the economic expansion that started in 1983. The economy will be responding to major revisions of the tax system, a much reduced value of the dollar against the currencies of other countries, and the beginning of budgetary restraint. Although each of these developments is welcome, the year will end with still unresolved problems caused by the large foreign trade and budget deficits that have been allowed to develop over the past several years.

Trade and the Dollar

Because the foreign trade deficit is so central to current and prospective economic conditions, I begin with a discussion of its causes and cures. The trade balance depends mainly on the relative competitiveness of U.S. goods against those produced abroad. Competitiveness, in turn, depends on the real exchange rate of the dollar against other currencies. Why exchange rates move as they do is not perfectly understood. But, particularly for the United States with its immensely liquid capital markets, the exchange rate is influenced by differences in what capital can be expected to earn here and abroad.

U.S. real interest rates rose to historic levels at the start of this decade and stayed high as the prospect of record, chronic U.S. budget deficits emerged. Foreign capital was attracted to the yields available on U.S. investments, and this demand for dollar assets drove the dollar steadily higher. As it rose, U.S. products became steadily less competitive against foreign goods, and imports grew considerably faster than exports. In 1986 the merchandise trade balance was in deficit by $170 billion.

The nation's current account — the sum of the balance on foreign trade in goods and services and the net payment of interest and profits to and from foreigners — first moved into deficit in 1982 and reached a deficit of $140 billion last year. Over that period current account deficits have cumulated to $420 billion and will add up to more than $700 billion by the end of 1990, even on an optimistic projection of how rapidly trade deficits now decline.

On the other side of the ledger, the current account deficits correspond to capital inflows from abroad in equal amount. The $700 billion cumulative inflow will represent a net accumulation by foreigners of dollar assets, which, if they yield an average return of 8 percent, will require annual interest and profit payments abroad of $56 billion indefinitely.

In market economies exchange rates eventually move to correct excessive imbalances in the current account. Because U.S. deficits must be financed by corresponding inflows of foreign capital, the dollar would stay high in the face of

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growing current account deficits only if foreigners wanted to invest growing amounts in dollar assets. For an extended time, the budget deficit kept U.S. interest rates high, making such investments attractive. The dollar's continuous rise may have made them appear more attractive still. But eventually, in early 1985, the balance between the dollars required to finance growing current account deficits and the dollars foreigners wanted to invest in U.S. assets tipped, and the dollar began to decline. At that point, it had risen for four years to a level that was 49 to 79 percent above its 1980 value against a weighted average of other currencies, depending on which of two widely used methods of averaging is used.

The decline of the dollar was aided by the Plaza agreement in September of 1985 in which finance ministers of five major industrial nations agreed its exchange value should fall and to intervene as necessary in foreign exchange markets to ensure that fall. By the fourth quarter of that year, the dollar had dropped by more than 20 percent against the currencies of most industrial nations in Europe and Japan. As it continued to decline during 1986, falling another 20 to 25 percent against these same currencies, other governments feared that the loss of competitiveness of their own industries was becoming excessive, and the Plaza agreement disintegrated (see table 1).

Even in the United States, there were divisions among policymakers about whether a continued dollar decline was desirable. By raising the dollar prices of foreign goods, dollar devaluation raises the prices of imports and puts some upward pressure on the prices of tradeable goods produced in the United States — those goods that compete with imports or in export markets. U.S. policymakers are concerned that this process could add excessively to the U.S. price level and that, by starting a price-wage spiral, it could ratchet up the underlying inflation rate.

These concerns in themselves are not a reason to oppose dollar devaluation because raising the dollar prices of foreign goods is the way in which devaluation improves the trade balance. These price level effects are therefore inevitable. Furthermore, there is no reason to believe that a given increase in foreign prices poses less risk of accelerating the ongoing inflation rate here if it occurs over a longer rather than a shorter period of time. Conversely, delaying the needed devaluation delays the needed improvement in the trade balance. Fears of devaluation going too fast do not seem well-founded.

Going too far is a different matter. There is reason to avoid an overshooting of the dollar's needed correction, for that would add unnecessarily to price level pressures. As the various measures in table 1 indicate, by the fourth quarter of 1986 the real exchange rate of the dollar — the nominal exchange rate adjusted by an overall price index for each country — had fallen to levels near or below those of 1980, when the U.S. current account was near balance. In light of this drop, many observers judged that the dollar had fallen far enough. But two considerations suggest that it may have farther to go.

First, the current account deficit continued to widen during 1986, and even if it soon starts to improve, econometric studies suggest it will not approach balance with the exchange rates that prevailed late last year. These studies imply that a downward trend in the real exchange rate of the dollar — and trend increases in the real exchange rates of the yen and D-mark — are needed to maintain current account balance for these countries. Some continuations of these trends — which presumably reflect quality changes in goods or inadequacies of the overall price indexes as price indicators for tradeable goods — would mean the real exchange rate must now fall some distance below its 1980 level.

Second, holdings of dollars by official foreign sources — a proxy for intervention in exchange markets — rose by $41 billion during 1986 and continued to rise early in 1987. In other words, at the exchange rates that prevailed during the

Table 1. Exchange Value of the Dollar, 1980–87

Currency	1980	1981	1982	1983	1984	1985:1	1985:4	1986:4	Feb. 6 1987
Yen									
Nominal	100.0	97.3	109.9	104.7	104.8	113.7	91.3	70.8	68.1
Real[a]	100.0	104.7	118.5	116.9	120.1	129.2	108.1	88.7	85.3
Deutsche mark									
Nominal	100.0	124.3	133.5	140.5	156.6	179.1	142.2	110.4	102.2
Real[a]	100.0	125.8	130.2	136.7	151.6	169.6	134.2	103.8	96.1
Multilateral[b]									
Nominal	100.0	117.7	133.4	143.4	158.2	179.1	146.7	122.4	114.2
Real[c]	100.0	118.9	131.7	138.3	151.5	169.9	139.6	116.6	109.4
Bilateral[d]									
Nominal	100.0	109.7	121.1	125.9	135.0	149.0	129.3	113.4	107.7
Real[a]	100.0	112.1	121.6	125.4	133.0	143.8	124.4	110.8	104.1

a. Nominal exchange rates adjusted by wholesale price index for manufactured goods in each country.
b. Federal Reserve Board index using multilateral trade volumes as weights.
c. Nominal exchange rates adjusted by consumer price index in each country.
d. Morgan Guaranty Trust index using bilateral trade volumes as weights.

Sources: Board of Governors of the Federal Reserve System, Morgan Guaranty Trust, and author's calculations.

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". . . the U.S. government should not intervene in exchange markets against normal market forces that would move down the dollar and should try to discourage foreign governments from doing so as well. Confronted with the present uncertainty over how far the dollar must fall, it would be better to err in the direction of letting it fall too far rather than keeping it from falling far enough."

past year, private capital inflows into the United States were themselves not large enough to finance the current account deficit. Without official intervention, the dollar would have fallen even farther than it has.

Eventually, a lower value of the dollar will improve the competitiveness of U.S. industries enough to return the trade account to near balance. If the market pressures from holders of dollar assets are great enough, the dollar will decline even farther so as to produce a trade surplus with which to service the interest and profit payments on the investments accumulated by foreigners. In the meantime, considerable uncertainty will continue over how far the dollar must fall to accomplish the needed improvement in trade and how quickly that improvement will take place. Because securing that improvement is both vital and urgent, the U.S. government should not intervene in exchange markets against normal market forces that would move down the dollar and should try to discourage foreign governments from doing so as well. Confronted with the present uncertainty over how far the dollar must fall, it would be better to err in the direction of letting it fall too far rather than keeping it from falling far enough.

Risks to Stability

This general prescription would be sorely tested if foreigners, and Americans too, for that matter, suddenly become less willing to hold dollar assets. A spontaneous shift out of dollars would cause a precipitous fall in its value that might well overshoot the needed correction. Moreover, if the shift occurred by selling dollar-denominated bonds and stocks, the cost of raising debt and equity capital would go up, U.S. investment would be reduced, and the economy could turn down into recession. A sudden shift away from dollar assets is highly unlikely. But its possibility helps explain why policymakers want to maintain orderly foreign exchange markets and why they are willing to intervene in those markets to keep them orderly.

The risk of dollar instability could also compromise conventional countercyclical policies, because policymakers would be concerned with the foreign exchange market as well as with the domestic economy. If at some time in the future a recession should emerge, the monetary authorities might not want to lower interest rates aggressively for fear they would trigger an excessive fall in the dollar. Even if they were more concerned with recession than with the dollar, the probability of a recession deepening would be hard to calculate. Confronted with inevitable uncertainties about the state of the economy and at the same time concerned with maintaining orderly foreign exchange markets, the Federal Reserve might well be reluctant to ease rates.

The large budget deficits pose a related problem for using fiscal policy to counter a recession if one should emerge. Because recession would already have made the projected budget deficit much larger, the president and Congress might be unwilling to support the economy with fiscal stimulus that would, in the short run, make the deficit larger still. Again, however, a temporary enlargement of the deficit would be preferable to letting the recession deepen.

These possibilities are risks, not most probable outcomes. Reducing the trade and budget deficits would calm markets and lessen the likelihood that policymakers could be frozen

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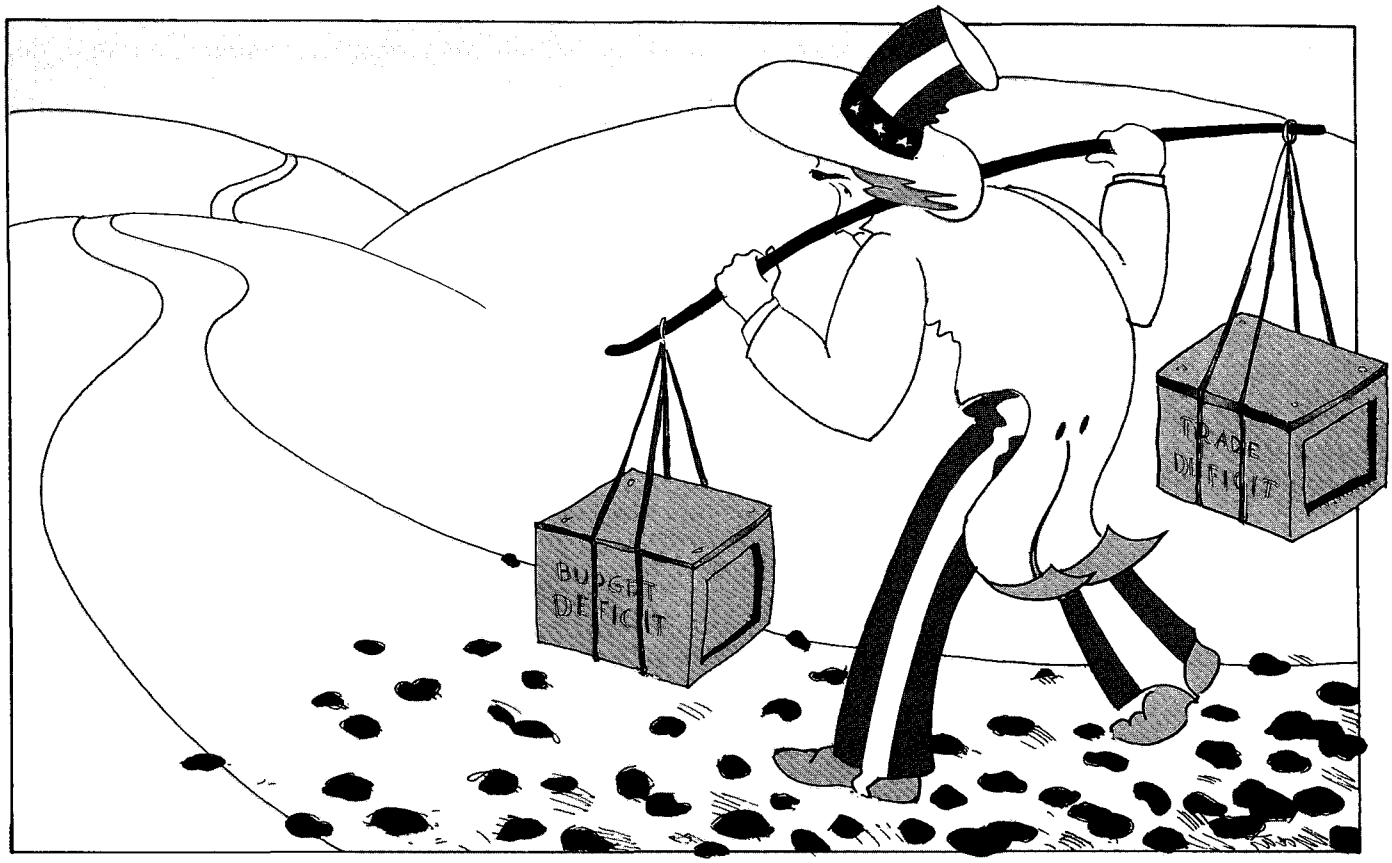

into inaction. Signs that this needed adjustment is not taking place would have the opposite effect. However, the problems associated with the twin deficits took several years to develop and cannot be eliminated overnight. Policymakers can encourage our trading partners to grow faster and to permit market forces to move the dollar. They can negotiate to open markets for our exports where barriers exist. But how soon and how fast the trade balance improves is only very loosely controllable.

Policymakers have more direct control over the budget deficit. But even leaving aside the political stalemate that has prevented more progress in the past, the pace of deficit reduction must take account of the likely state of the economy. Because cutting the budget deficit will, in itself, reduce total demand in the economy, how fast it should be cut will depend on how strongly other sources of demand, including demand coming from the foreign trade sector, are rising to fill the gap.

Projected Growth in 1987

Based on present best judgments about the budget and monetary policy and the strength of demand in different sectors, I expect real GNP to rise by 3 percent in 1987 and by 4 percent between the fourth quarters of this year and last. This forecast anticipates budget deficits of $180 billion for FY 1987 and $150 billion for FY 1988, a projection that is discussed more fully below. Monetary policy is expected to keep key policy variables, such as the federal funds rate, little changed for the present, with some firming of rates later in the year as the strength in the economy becomes more apparent.

Prices, measured either by the consumer or producer price index, will rise noticeably more than they did in 1986 because of higher oil prices and a larger increase in import prices. However, those higher prices will not generate a corresponding acceleration of the underlying rate of inflation that is likely to be lasting. The underlying inflation rate has been remarkably stable over the past three years and was steady or went down during 1986 using any of several alternative price and wage measures (see table 2).

What are the prospects in individual sectors that underlie the overall forecast of GNP? Weak domestic demand has not been the cause of the lackluster GNP growth we have experienced since 1984. Indeed, fueled by the stimulus of very large budget deficits and some decline in real interest rates, real domestic final sales, a measure of domestic demand, have been rising at an average annual rate of 3.9 percent over the past two years. However, until the last quarter of 1986, much of this growth in domestic demand was satisfied by increased imports rather than by domestic production. Thus, a worsening trade deficit held down the growth of GNP, accounting for more than half of the difference between the 2.5 percent GNP growth and the much stronger growth of domestic demand over this period (see table 3).

Real domestic demand can be expected to grow more slowly in 1987 than it has in recent quarters. Consumer spending, which had been one of the strongest sectors of demand in 1986, will get some support from lower personal tax collections under the first stage of tax reform. By disallowing sales tax deductions starting this year, however, tax reform also pushed some consumer demand into 1986 from 1987, helping to bring the personal saving rate in

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"The more competitive dollar has revived sales and margins in basic export industries such as lumber, chemicals, and paper and is improving prospects for capital goods manufacturing as well. It is also improving the picture for industries that compete with imports."

the last half of the year down to 2.7 percent, compared with a 6.6 percent average for the first five years of this decade. On balance consumer spending will grow only moderately this year. Similarly, the level of single-family housing starts and related construction activity is not expected to change much between this year and last.

The effects of tax reform on the incentives for various types of investment are hard to predict with precision, which makes the near-term outlook for business investment spending exceptionally uncertain. Lower corporate tax rates, with the maximum at 34 percent rather than the previous 46 percent, are in themselves a stimulus to business investment. However, other changes in the tax law reduce investment incentives and, by more than offsetting the effects of rate reductions, leave prospective corporate tax liabilities higher by about $25 billion a year. As a consequence, total corporate cash flow will increase only slightly between 1986 and 1987, despite a relatively large increase in pre-tax profits.

Consistent with its objective of providing a level playing field for all forms of investment, the new tax law reduces the tax-shelter incentives and overly generous depreciation allowances on structures that had helped fuel office building and multifamily residential building. Eliminating the investment tax credit (ITC) also raises the effective cost of investing in business equipment. However, the ITC was repealed retroactive to the start of 1986, so most of the effects of repeal should have already shown up in equipment spending last year. The net near-term effect of tax reform on total business investment in 1987 is likely to be moderately negative.

Other determinants of business investment spending are looking up. The more competitive dollar has revived sales and margins in basic export industries such as lumber, chemicals, and paper and is improving prospects for capital goods manufacturing as well. It is also improving the picture for industries that compete with imports. This brighter outlook for sales over a range of manufacturing industries will, in turn, encourage them to invest more to expand and modernize their facilities. For the year, real business investment will rise moderately, despite the negative effects of tax reform on construction. If the trade balance continues to improve, investment spending should

Table 2. Actual and Underlying Inflation

Measures	Year ending 1982:4	1983:4	1984:4	1985:4	1986:4
Actual rate					
Consumer price index (CPI)	4.5%	3.3%	4.0%	3.5%	1.3%
Producer price index (PPI)	3.6	0.8	1.7	1.6	−1.9
GNP fixed weight deflator	5.0	3.9	3.9	3.6	2.4
Underlying rate					
CPI less food, energy, shelter, and used cars	6.1	4.1	4.2	4.1	4.1
Consumption deflator less food and energy	5.8	4.8	4.1	4.6	3.5
PPI less food and energy	4.9	2.1	2.2	2.7	2.6
Average hourly earnings index	6.0	3.9	3.0	3.2	2.2
Employment cost index (compensation)	6.4	5.7	4.9	3.9	3.2

Sources: Bureau of Labor Statistics; Bureau of Economic Analysis.

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Table 3. Real GNP and Domestic Demand

	Percent changes, annual rate				
	1984:4-1985:2	1985:2-1985:4	1985:4-1986:2	1986:2-1986:4	Two-year average
Real GNP	2.7%	3.1%	2.2%	2.0%	2.5%
Real domestic demand*	4.6	4.1	3.9	3.1	3.9
Difference	−1.9	−1.0	−1.7	−1.1	−1.4
Due to trade balance	−0.8	−1.4	−1.2	0.3	−0.8

*Real domestic final sales less purchases of agricultural goods under price support programs.

Source: Author's calculations using data from the Bureau of Economic Analysis.

grow stronger as the year progresses.

The combination of these private demands, together with only slowly rising government spending, means that total domestic demand will grow less rapidly in 1987 than in recent years. In contrast to the 1984–86 period shown in table 3, when modest GNP growth was sustained by brisk domestic demands that compensated for a worsening trade balance, the outlook now requires an improving trade balance to sustain the growth of total GNP in the face of slowing domestic demands. Though hardly assured, I expect that improvement to take place.

I expect the real trade deficit to narrow by $15 billion to $20 billion in 1987 and by substantially more than that between the fourth quarters of last year and this year. Without this improvement, the projected growth of GNP would be hard to achieve. Thus for the next several quarters, the outlook for overall U.S. economic performance is going to depend on developments in the foreign trade sector that are notoriously difficult to forecast and that disappointed most observers in 1986 when the trade deficit grew markedly from the year earlier.

If, contrary to present expectations, the real trade deficit continues to widen during 1987, it would not only subtract directly from GNP growth but also weaken domestic demands by retarding the growth of incomes and reducing incentives for business investment. In this case, aggressive policy stimulus could be required to avoid a recession. In view of the longer run adjustments that are needed, that stimulus should come mainly from a reduction in interest rates, an action the Federal Reserve might be reluctant to take for fear that it would weaken the dollar further. Yet, a weaker dollar would be an acceptable, perhaps an even desirable, result in light of the longer run adjustments that are needed.

The Economy in Longer Perspective

Measured against performance over the entire postwar period, the 1980s have thus far been a disappointing decade for economic growth. Annual gains in real GNP averaged only 2.0 percent compared with 2.8 percent, 4.1 percent, and 3.9 percent in the 1970s, 1960s, and 1950s, respectively. The slow growth of the 1980s reflects both poor productivity gains and a shortfall of actual economic performance below the economy's potential. The national unemployment rate, which was 5.8 percent in 1979, averaged 7.0 percent last year, and capacity utilization in manufacturing was 5.7 percent lower in 1986 than in 1979. Although unemployment should fall and operating rates rise in 1987, the economy will still be some distance from a full utilization of its resources.

This disappointing growth performance has been paralleled by historically low rates of net investment in manufacturing. Gross investment outlays have not been far from historical experience, but they have been concentrated in short-lived equipment that depreciates rapidly and is retired relatively quickly. Between 1980 and 1985, the net capital stock in manufacturing grew by only 1.3 percent a year. By contrast it grew at average annual rates of 3.3, 4.8, and 3.5 percent in the 1970s, 1960s, and 1950s, respectively.

In the first years of the 1980s, manufacturing investment was discouraged by historically high real interest rates and deep and prolonged recession. After surging briefly when the economy began to recover, investment slowed again in apparent response to continued low rates of capacity utilization, still high real interest rates, slow growth, and the reduced competitiveness that came with an overvalued dollar. Last year, despite the declining dollar, businesses remained cautious in their investment plans, presumably because of the continued overhang of excess capacity and sluggish prospects for future growth. A high rate of business investment is necessary for strong economic growth and a gradual improvement of living standards. Raising the proportion of GNP devoted to net capital formation, particularly in the manufacturing sector, should be an important aim of policy for the future.

In contrast to softness in business investment in the 1980s, there has been a relative binge of consumption spending. Through 1986 real consumption rose at an average annual rate of 2.8 percent a year, 0.8 percentage points faster than real GNP. Averaged over the previous three decades, consumption and GNP had grown at the same pace. A rising ratio of consumption to GNP must come about either by reducing the proportion of GNP going to meet other domestic demands or by importing more than we export and thus borrowing from abroad to make up the difference. The 3.3 point rise in the consumption-to-GNP ratio thus far in the 1980s has been accompanied by an even larger — 4.4 percentage point — rise in the trade deficit-to-GNP ratio. This borrowing from abroad has permitted not only the strong surge in consumption but also a substantial rise in the share of GNP going to defense purchases. As the trade deficit is reduced, increasing net foreign demands on our GNP, some domestic demands will have to decline as a

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share of GNP. To achieve this decline without forcing up interest rates, which would reduce total domestic demand by reducing its investment demand component, the budget deficit must be reduced. How fast, how far, and how it is reduced are questions I turn to next.

The FY 1988 Deficit

In the book *Economic Choices 1987,* published in 1986, I joined several colleagues in the opinion that the Gramm-Rudman-Hollings path for deficit reduction in 1987–89 represented a feasible tentative goal for budget policy. That path called for deficits to decline to $144 billion, $108 billion, and $72 billion in those three successive years. Our analysis projected a continued decline in the dollar exchange rate during 1986–88 that would reduce the trade deficit fast enough to offset the declining fiscal stimulus from the budget with a rising stimulus to demand from the foreign sector.

Today, those original deficit targets for fiscal years 1988 and 1989 appear too ambitious. The continuing political stalemate between the White House and Congress over expenditures and revenues is leaving the projected deficit for FY 1987 near $180 billion rather than the target level of $144 billion. To attempt to get back on target by reducing the deficit to $108 billion for FY 1988 would impose too sudden a fiscal restraint on the economy.

I earlier projected a $15 billion to $20 billion decline in the trade deficit in 1987, relatively weak growth in consumer and housing demands, and the start of a strengthening in business investment, though with considerable uncertainty in that sector because of tax reform. In light of these prospects and uncertainties, a FY 1988 deficit of $150 billion represents a sensible balancing of the twin needs to sustain adequate expansion in the short run and to reduce the deficit over time. A $150 billion deficit target runs some risk of reducing fiscal stimulus too fast in an economy whose strength is uncertain. But it is not such a large budgetary tightening that its effects could not be offset by lowering interest rates if the economy proved weaker than expected. At the same time, a $150 billion deficit represents clear progress in reducing the deficit, cutting it from 4.2 to 3.2 percent of GNP between FY 1987 and FY 1988.

That the deficit target of $108 billion for FY 1988 should not be met makes a virtue of necessity because there is little if any prospect of breaking the stalemate over how to meet it anyhow. That the attempt should not even be made is a rare piece of good news that the economist can offer the politician. That said, it must be added that the aim of steadily reducing deficits under conditions of adequate economic growth should not be compromised. Yet, budget politics has already brought forth fanciful proposals designed to disguise the deficit or to lay the blame for it on the political opposition.

In the first category, the president has again proposed selling real and financial assets of the government. Under government accounting principles, such asset sales are treated as negative expenditures and reduce the deficit in the year they are made. But whether the government sells new government bonds to meet its deficit or sells existing assets instead makes little or no difference to the impact of the budget on the available pool of savings and hence on macroeconomic performance. Either way, saving that would have been available to finance private investment will instead be diverted to buying bonds or other assets from the government.

In the second category, the rhetoric calling for a constitutional amendment to balance the budget has subsided, save for an applause line in this year's State of the Union address. Calls can still be heard, however, to allow the president a line-item veto on expenditures and to budget separately for capital and current expenditures, allowing the former to be financed by borrowing. The line-item veto would shift an enormous amount of authority and responsibility from Congress to the president, badly unbalancing the separation of powers between the executive and legislative branches and unduly increasing the political leverage of the president on program priorities. In principle capital budgeting can be a useful tool in decisionmaking. In practice it would raise a host of thorny issues, including which expenditures would be classified as capital and thereby freed from deficit constraints. More to the present point, the call for capital budgeting only obfuscates the issue of how large the total federal deficit should be, an issue that is unaffected by any division of expenditures into the capital and current categories.

Table 4: Projected Budget and Current Account Deficits (—)
(in billions of dollars)

	FY 1987	FY 1988	FY 1989	FY 1990
Projected budget deficits[a]				
CBO baseline	$-174	$-169	$-162	$-134
Tentative target path	-180	-150	-114	- 78
Difference	- 6	19	48	56
Projected current account deficit[a]	-125	- 90	- 55	- 20
Projections at trend GNP growth[b]				
Target path for budget	-180	-156	-126	- 96
Current account deficit	-125	- 85	- 45	- 5

a. Projections assume real GNP growth of 3 percent a year.
b. Projections are adjusted for differences in revenues and transfer payments (budget) and imports (current account) associated with 2.5 percent rather than 3 percent GNP growth.

Source: Author's projections.

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Budget Targets for the Longer Run

Tentative budget targets for the years after FY 1988 should take account of both the need to keep the economy expanding adequately and the decline in the current account deficit that will inevitably occur. The targets should be tentative because lawmakers should not be bound to meet them if doing so would endanger the economic expansion. Nor should specific targets be retained if they can be met only with budgeting sleight of hand. Yet targets are necessary to guide and discipline the budgetary process. At this distance, the pace of reductions originally specified in the Gramm-Rudman-Hollings law, $36 billion a year, appears a prudent tentative target path for an economy growing by 3 percent a year. Along this same growth path, it appears reasonable to anticipate annual declines in the current account deficit after 1987 of about the same magnitude.

The stimulus or restraint these changes will provide to the economy is best estimated by their corresponding values measured along the economy's trend growth path — the growth path that would keep unemployment and utilization rates unchanged. Because 3 percent annual growth is about half a percentage point faster than the economy's trend, these recommended target paths correspond to reductions of about $30 billion a year in the trend budget deficit and about $40 billion a year in the trend current account deficit. Thus the stimulus from the foreign sector would be slightly larger than the restraint from the budget. Table 4 summarizes these paths and compares the deficit path with the current services, or baseline budget, projected by the Congressional Budget Office.

How the differences between the target path and the CBO baseline are closed is a matter of political choice. The longer-term perspective on the U.S. economy presented above suggests both that business investment should be encouraged and that consumption spending should be restrained in future years to make room for more investment. This, in turn, implies that deficit reduction should be accomplished in large part through tax increases that restrain the rise in disposable incomes. If, for example, the entire $56 billion deficit reduction called for in 1990 were accomplished through an 11 percent increase in individual income tax collections, consumption spending might be lower by roughly $50 billion. This decrease would reduce the share of GNP devoted to consumption by a little less than one percentage point, in itself undoing about one quarter of the rise in the consumption share that occurred between 1979 and 1986.

The Deficit and National Priorities

The preceding analysis outlines the macroeconomics of deficit reduction — how that process will influence the pace of economic expansion and the division of GNP into the major categories of investment and consumption. But the budget also determines how much or how little we do in areas of public responsibility such as defense, health, research, poverty, education, the nation's infrastructure, and the effective delivery of public services. Rational budget decisions should reflect national priorities in these areas as well as macroeconomic goals. Reconciling the two will be impossible so long as it is politically taboo to consider raising revenues in the decision process.

"Rational budget decisions should reflect national priorities . . . as well as macroeconomic goals. Reconciling the two will be impossible so long as it is politically taboo to consider raising revenues in the decision process."

The Gramm-Rudman-Hollings targets have been disregarded until now because meeting them through spending cuts alone would distort the nation's priorities too badly. What is more, after several years of paring down nondefense spending, not only have low-priority programs been weeded out of the budget but high-priority needs have been neglected or underfunded. Yes, there are still good candidates for further spending cuts. But spending on some programs will have to rise even as deficits are reduced. It is shameful to deplore drugs and withhold the funding to combat them, to finance AIDS research by cutting cancer research, to ignore the homeless because poverty funds are limited, to choose between plane crashes and train wrecks, and to penny pinch the essential housekeeping chores of government to levels not befitting a wealthy and proud nation.

As important as deficit reduction is, it should not be allowed to override all other responsibilities of government. Until the need to raise revenues can be brought into the budget debate, Congress will, quite properly, run larger deficits than would otherwise be desirable.

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The External Deficit: Why? Where Next? What Remedy?

Ralph C. Bryant and Gerald Holtham

THE CURRENT ACCOUNT DEFICIT in the U.S. balance of payments, for most of the 1980s, was just an economic statistic confined to the business pages. Now, however, that external deficit is a central economic and political issue that generates front-page headlines.*

The new public interest is justified. Because of the deterioration in the external deficit since 1980, the United States has slipped — suddenly and dramatically — from being the world's largest creditor country to being its largest debtor. An external deficit as large as the existing one — some $150 billion in 1986 — is very difficult to remove quickly. Fears that U.S. indebtedness will continue to grow, perhaps to an alarming extent, are well-founded.

Unfortunately, increased interest in the external deficit has not led to an increase in clear thinking about it. In the United States, ill-informed commentators assert that recent depreciations of the dollar are failing to reduce the external deficit. Protectionist sentiment is intense, even though the deficit was not caused by growing protectionism abroad and will not be cured by it at home. Facile critics in other countries call on the United States to "put its house in order" — always good advice, especially applied to someone else's house — with no apparent awareness of the likely consequences if the advice were implemented. Some foreign governments seem to believe that, while a further depreciation of the U.S. dollar would be bad for them, a recession in the United States would be a matter of indifference. In either event, they are reluctant to assume public responsibility for the level of demand in their economies.

Against this background, a recent workshop at Brookings assessed the origins of the U.S. external deficit and the prospects for its decline. Participants from several countries prepared and evaluated econometric and other evidence (see box). This article, informed by those analyses, discusses the causes of the external deficit, its probable future evolution, and the best means to reduce it. The conclusions here, it should be stressed, are our own. Participants in the workshop have not reviewed this article and do not necessarily sanction its inferences.

Why the Deficit Ballooned

There is no mystery about the causes of the swelling U.S. external deficit. They are chiefly macroeconomic. Other causes commonly said to be important, such as "unfair trading practices" abroad or structural changes in the U.S. and foreign economies, simply do not explain most of what has happened.

The Brookings workshop firmly established this conclusion. A half-dozen macroeconometric models were asked to "predict" the external deficit for the period 1980–86 by running their equations for the volumes and prices of exports and imports. All of the models took as given the historical values for exchange

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rates, domestic prices, and economic activity in the United States and other countries. Every model predicted current account deficits close to their actual values. The predictions were often within a few billion dollars in 1986, five years after the start of the dynamic simulations.

To be sure, the experiment showed that the models are limited in their ability to forecast detailed patterns of trade. Mistakes were made over components of the current account balance. However, different models made their larger mistakes over different components. There were few common surprises. Furthermore, the more successful models showed no sign of errors growing over time. They were as likely to make a sizable mistake for 1980 as for 1985. That fact is strong evidence against the assertion that there has been a break in historical relationships. Such a break would lead to sustained or cumulating prediction errors.

What were the chief movements in the components of the external deficit associated with its emergence and widening since 1980? Prices were not to blame; the dollar prices of nonagricultural exports and non-oil imports showed relatively little net change over the 1980–86 period. The swelling deficit stemmed from a doubling in the quantity of non-oil imports while U.S. manufactured exports stagnated and agricultural exports fell sharply. Against that, the fall in oil prices, combined with energy conservation efforts, led to a sharp drop in the value of oil imports. These movements in the components of the trade balance combined to produce the 1980–86 deterioration of $127 billion. A further deterioration of $20 billion occurred in the non-trade components of the current account. These changes are summarized in table 1.

Among the proximate factors used by models to "explain" the external deficit, two are overwhelmingly important: strong U.S. domestic demand growth during a world recession combined with a relatively feeble recovery abroad; and the large appreciation of the dollar from 1980 through early 1985. A factor that seems to be important but that the models do not adequately capture is the debt crisis and persistent weakness of activity in developing countries, which were important markets, particularly for U.S. agricultural exports.

The existence of several factors all working in the same direction, tending to widen the deficit, means paradoxically that the deficit is "too" easy to explain. The deterioration can be accounted for in different ways by giving different weights to the various factors.

For example, one of the models suggests that if U.S. and foreign GNPs had remained at their 1980 levels, everything else being equal, about a quarter of the U.S. external deficit would not have occurred. If relative prices in the United States and abroad had remained at their 1980 levels, about three-quarters of the deficit would not have occurred. The changes in price competitiveness that occurred can be traced to the rise of the dollar between 1980 and 1985. Other factors that tended to worsen the deficit were more than offset by favorable elements such as the decline in oil prices.

Other models participating in the workshop give a somewhat different breakdown. One places much more importance on relative growth rates, leaving less than two-thirds of the deficit to be explained by competitiveness (primarily exchange rate) effects. Two give slightly more relative weight to dollar appreciation. These differences have more than historical significance. They mean that, even on the basis of common assumptions, the models predict different evolutions of the deficit from now on.

Economic analysis is less secure in analyzing the fundamental causes of the external deficit — for example, the factors that caused exchange rates and GNPs to move as they did. Growth differentials between the United States and the other members of the Organization for Economic Cooperation and Development (OECD) are substantially explicable by policy differences, particularly relative fiscal policies, which were expansionary in the United States after 1981 and equally contractionary elsewhere. On the basis of actual fiscal and monetary policies, however, the models would have predicted only one-half or less of the rise in the dollar that actually occurred. No empirical economic model can successfully explain the remaining appreciation, particularly not the surge in 1984 and the first months of 1985. That failure means in turn that the models are capable of predicting only half to two-thirds of the external deficit on the basis of policies alone.

Why the Deficit Has Stayed So Large

By February 1987 the external deficit showed little apparent improvement, even though the dollar had been depreciating for nearly two years. Why, it is frequently asked, is the adjustment taking "longer than expected"?

Is it really taking longer? Our answer, drawing on the workshop finding that the models correctly track the deficit right into the second half of 1986, is no. Expectations that the improvement would take less time are based on incomplete or faulty analysis.

The effective depreciation of the dollar relevant to its effects on the current account balance is less than the steep decline since the short-lived peak of February–March 1985. That peak was not sustained very long and was never

"Protectionist sentiment is intense, even though the deficit was not caused by growing protectionism abroad and will not be cured by it at home."

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incorporated in trade prices. And while the dollar fell throughout the last three quarters of 1985, its average effective value during 1985 was still well above its average value during 1984. Period averages are more important than day-to-day quotations in assessing the influence of exchange rates on trade prices.

When the path of the dollar's exchange value is correctly incorporated into the analysis, the time taken for the external deficit to begin improving is not a surprise. Relationships based on history make it clear that a lengthy period for the turnaround is necessary. First, trade prices respond sluggishly to exchange rate movements; this lag is especially important for the dollar prices of U.S. imports. Second, the volumes of exports and imports (flows at constant prices) react slowly to changes in relative prices; distributed lags extending beyond two years are common in trade models. Third, though both react slowly, trade prices adjust faster than trade volumes, leading to a short-run worsening of the current price balances, the so-called "J-curve" effect. (In particular, import volumes initially decline less in response to dollar depreciation than import prices rise, leading in the first instance to an increase rather than a fall in the value of imports.) Even though the trade and current account balances initially fail to improve at current prices, a gradual improvement in the constant price balances does begin immediately. Given the nearly continuous depreciation of the dollar over the past two years, moreover, an entire family of J-curves has been in effect. The deficit must navigate around the whole family of curves before the full effects of the exchange rate changes become evident.

Other countries typically have waited two years or more to see the benefits of a currency depreciation. In addition, adjustment of the U.S. external deficit in response to

Table 1. The U.S. External Deficit by Major Component, 1980–86

Component or balance*	1980	1986**	Change from 1980 to 1986 $ amount	% change
Nonagricultural merchandise exports				
Current dollars	$183	$194	$ 11	6%
1982 dollars	203	208		3
Price index	90	93		3
Agricultural merchandise exports				
Current dollars	42	27	–15	–37
1982 dollars	39	30		–24
Price index	108	90		–17
Non-oil merchandise imports				
Current dollars	168	335	167	99
1982 dollars	171	344		102
Price index	99	97		– 1
Oil imports				
Current dollars	79	34	–45	–57
1982 dollars	83	76		– 8
Price index	96	47		–51
Net receipts, investment income				
Current dollars	48	37	–10	–22
1982 dollars	56	33		–41
Net receipts, other services				
Current dollars	7	7	– 0	– 6
1982 dollars	13	0		–97
Net transfer payments to foreigners				
Current dollars	7	15	8	112
Trade balance				
Current dollars	–22	–149	–127	
Balance on current account				
Current dollars	2	–145	–147	
Real net exports of goods and services				
1982 dollars	57	–150	–207	

*Figures for current dollars and constant 1982 dollars are in billions. Figures for the price indexes use a base of 1982 = 100. Dollar and percentage changes are calculated from unrounded figures.

**Preliminary figures. Data for net transfer payments and current account balance partially estimated by authors.

Source: Bureau of Economic Analysis, *Survey of Current Business.*

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currency depreciation is probably slower than it would be for other countries. The U.S. domestic market is the world's largest and most important. It is likely that foreign exporters take account of U.S. domestic prices and set their own prices competitively, rather than applying a fixed markup on their costs. In other words, foreign suppliers accept more variable profit margins in their effort to keep a position in the U.S. market than they do elsewhere and more than U.S. suppliers accept when exporting. Such pricing behavior is not a surprise; several models predict it. Nor does it negate the effects of exchange rate changes on trade, but it does slow down speeds of adjustment. Eventually, import prices come to reflect foreign costs, or the supply of foreign goods falls back, reflecting the lower profit margins in the U.S. market and a consequent reduced investment in marketing imports. This latter effect, however, can take years to reveal itself fully.

Will the Deficit Ever Decline?

If there is little or no mystery about the recent history, what lies ahead for the U.S. external deficit? Consider first the prospects for the next two years.

The models participating in the Brookings workshop were asked to project the external deficit and its components, at both constant and current prices, using the assumptions that the U.S. and foreign economies each grew at similar rates and that the exchange value of the dollar remained unchanged in real terms from the average value prevailing in the third quarter of 1986.

Between the third quarter of 1986 and late January 1987, the dollar declined by another 6 to 9 percent (the amount varying with the type of index used). The likely effects of that additional depreciation can be roughly calculated from other workshop materials. Figure 1 shows the actual history of constant price net exports of goods and services through 1986 and projections of the various models for 1987–91 adjusted for an additional 10 percent dollar depreciation. Figure 1 also shows a "combined-model" projection, calculated using weights based on the relative performance of the models in predicting the 1980–86 history.

Given the specified assumptions, the models agree that there should be sizable improvement in the constant price deficit during 1987–88. Projected net exports of goods and services at constant 1982 prices improve by as much as $30 billion to $35 billion in 1987 and by almost as much in 1988.

For the external deficit at current prices, calculations of a combined-model projection show an improvement of some $25 billion to $30 billion in the next two years, although it comes entirely in 1988.

It is the deficit in current prices that gets the lion's share of public attention. And the current price balance does show what the United States must borrow abroad to finance the deficit. Yet it is the deficit in constant prices that is relevant for assessing influences on real GNP and jobs, both in the U.S. economy and abroad. For 1987–88, moreover, the reduction in the constant price deficit is significantly larger than the improvement measured in current prices.

Unfortunately, prospects for improvement are not so rosy as one looks beyond the next two years. The models differ considerably in their projections of the external deficit for 1989–91 (see figure 1). The greatest variation stems from different estimates of the consequences of dollar depreciation. Still, there is a consensus that the depreciation that occurred through late January will not be sufficient to eradicate the deficit at either current or constant prices. If there is no further dollar depreciation, and if the U.S. and rest-of-world economies were to grow at roughly similar rates, the lagged effects of the currency changes occurring through January 1987 would have largely worked themselves out by 1989. Indeed, weighted averages of model projections show the trade and current account balances deteriorating again after 1989. As a percentage of GNP, the current account deficit never reaches its 1986 level of about 3⅓ percent, but after falling to a low around 2 percent in 1989, it rises slightly thereafter.

With the external deficit still fairly large even after 1989, the net external debt position of the United States would still grow rapidly. Correspondingly, debt service payments to foreigners would continue to increase, adding larger and larger negative numbers to the current account.

Virtually all analysts expect a continuing deterioration in the net external asset position, and hence the growing burdens of debt servicing. The prediction that the current balance will start to worsen again after 1989, therefore, is likely to be robust. Because of technical differences in model specifications, however, we would not be inclined to

The Brookings Workshop

The workshop on the U.S. current account imbalance, held at Brookings on January 20, 1987, compared alternative empirical approaches to analysis of the U.S. external deficit, seeking to improve understanding of the reasons for the deficit and to shed light on policy options for correcting it. The workshop is part of a research program entitled Macroeconomic Interactions and Policy Design in Interdependent Economies, jointly sponsored by Brookings and the Centre for Economic Policy Research in London and financed by a grant from the Ford Foundation.

The participants, acting as individuals, not representatives of their institutions, included analysts who are responsible for the construction and operation of the following econometric models: Data Resources International Model (DRI), Japanese Economic Planning Agency World Model (EPA), Federal Reserve Board staff Multicountry Model (MCM), the Global Economic Model of the National Institute for Economic and Social Research in London (GEM), the OECD Interlink Model (OECD), John Taylor's Multicountry Model (TAYLOR), and Wharton Econometrics International Model (WHARTON). All model groups, using uniform assumptions, reported the results of historical-tracking experiments; some groups carried out forward-looking simulations. In addition, papers were presented by William Helkie and Peter Hooper on "The U.S. External Deficit in the 1980s: An Empirical Analysis" and by Paul Krugman on "Has the Dollar Fallen Enough?"

Single copies of the model groups' reports, comparative materials based on those reports, and the papers, including a more detailed version of this article, are available in the form of Brookings Discussion Papers in International Economics.

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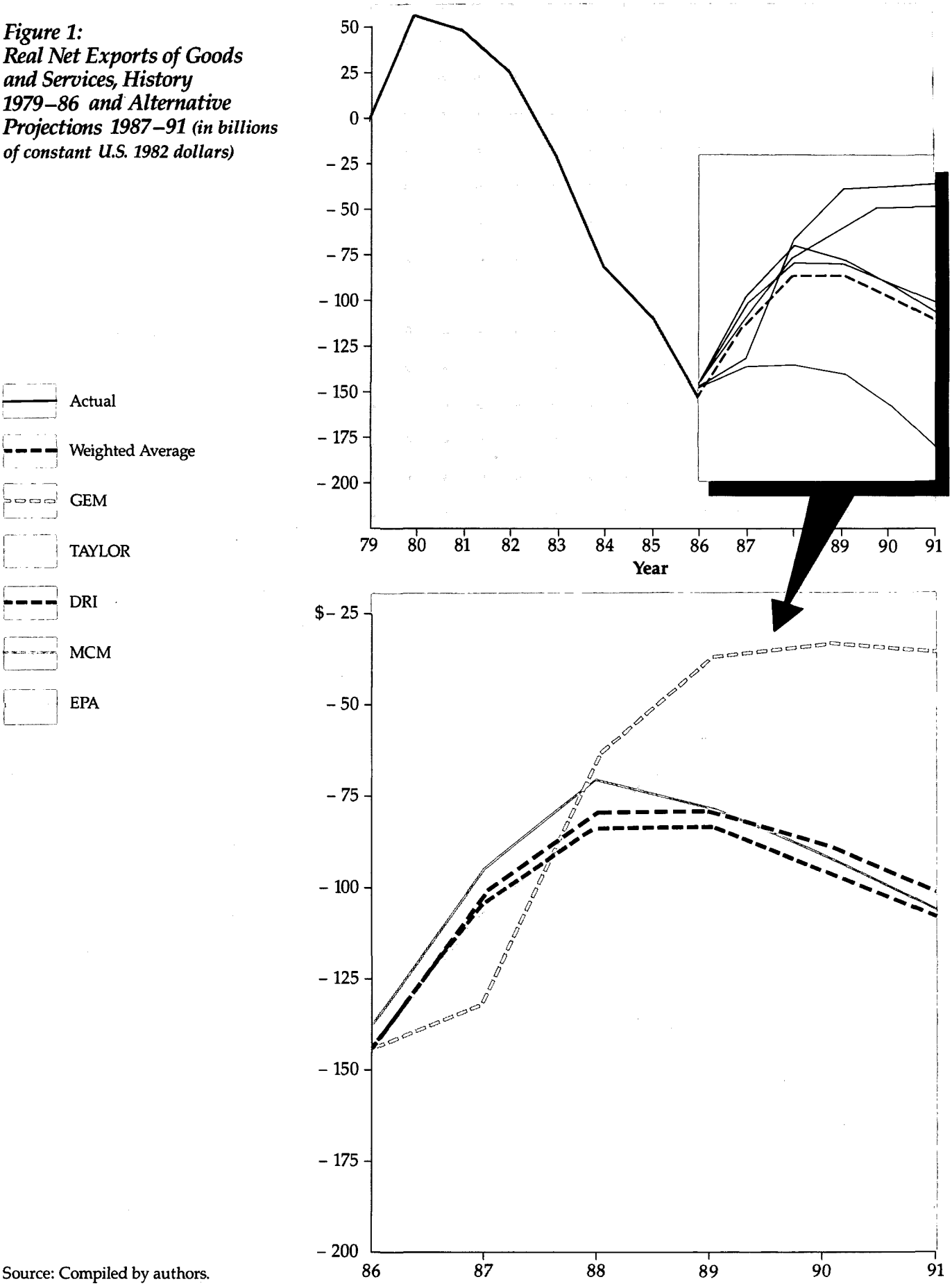
Figure 1:
Real Net Exports of Goods and Services, History 1979–86 and Alternative Projections 1987–91 (in billions of constant U.S. 1982 dollars)



Source: Compiled by authors.

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put too much weight on projections of a deterioration in the trade balance after 1989. At any rate, it is a matter of concern for policy that the trade deficit could get stuck above $100 billion, while the current account deficit deteriorated in relation to GNP.

A mechanical application of model results might appear to suggest that a further depreciation of the dollar against all other currencies — not simply the yen and the currencies of the European Monetary System — of 20 to 30 percent would be necessary and sufficient to achieve eventual elimination of the U.S. external deficit. Such an inference, however, would not be justified. The model calculations underlying such an inference are partial, the result of changing one variable, such as the dollar's exchange value, while all others are held fixed. In practice such a large additional depreciation would not leave all other variables unchanged. On the contrary, it would have a strong inflationary impact in the United States and a deflationary impact abroad. Both of those effects would tend to feed back on the external balance, limiting its improvement. Indeed, if the United States were able to achieve a swing in its real net exports of goods and services of even $100 billion, the domestic economy would probably overheat in the absence of other policy measures.

Moreover, the exchange value of the dollar is not a policy instrument that can be manipulated at will by governments. When assessing the probable effects of a large dollar depreciation, it is thus necessary to ask what induced the depreciation. The effects of a further 30 percent drop in the dollar would be quite different if the decline were brought about by a shift in market expectations than if it were a result of deliberate monetary policy.

All in all, a safer inference is that while the decline in the dollar from early 1985 to early 1987 will make a substantial contribution to reducing the external deficit, and while some further depreciation is probably in order, it is highly unlikely that the deficit problem can be solved by dollar depreciation alone. The conclusion is inescapable that other public policy action is required.

Risks of Recession in the World Economy

That conclusion is strengthened when the prospects for demand and output in the world economy are taken into account. During the years when the U.S. external deficit was worsening, U.S. real GNP grew on average at an annual rate of less than 2½ percent, while total domestic demand at constant prices grew at over 3½ percent. The growing excess of imports over exports was a significant drag on the expansion of the economy. In 1986 the deterioration in the external balance at constant prices cost about one percentage point of growth.

If the external balance at constant prices simply fails to deteriorate in 1987, and if domestic demand holds up, growth would be 1 percent faster than in 1986. The model projections summarized earlier, moreover, imply a further boost to the 1987 growth rate of nearly one percentage point. The total swing in the external balance could therefore add up to two percentage points to the 1987 growth rate relative to the 1986 rate. Of course, that figure also depends on particular assumptions about foreign demand growth, which might well not be realized.

For the world economy as a whole, faster U.S. growth due

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"A growth recession abroad is not sure to happen. It is not even the most probable outcome. It is nonetheless a distinct possibility and is certainly the gravest risk now facing the world economy, threatening much more than the orderly shrinkage of the U.S. external deficit."

to a swing in the external balance is at someone else's expense: in effect, coins are taken out of the left pocket and put into the right. Thus in sharp contrast to 1983–86, when the growing U.S. current account deficit supported growth in the rest of the world, correction of the deficit must now subject foreign economies to a strongly contractionary influence.

Prospects for real growth in Europe and Japan during 1987–88 are already soggy. Last December the OECD Secretariat, for example, forecast real growth in 1987 for OECD countries other than the United States of only 2¾ percent. Economic indicators released subsequently suggest that domestic demand is growing more slowly than expected, particularly in Germany. The dollar has already depreciated by an additional 4 to 7 percent since the OECD and other year-end forecasts were made, further weakening net export prospects abroad. It is not clear, moreover, that many forecasts allowed for as large a constant price swing in the U.S. deficit as we believe could occur.

These considerations raise a disturbing possibility. The rest of the OECD is much too close to the prospect of a real growth rate below 2 percent — a growth recession by any reasonable definition.

The direct impact on the U.S. external deficit of slower foreign growth is substantial. Model calculations suggest that 1 percent slower foreign growth could enlarge the deficit by as much as $20 billion to $30 billion over four years. Indirect effects must be considered too. Slower foreign growth could reduce interest rates and depress stock markets abroad and so tend to prop up the dollar. A growth recession starting in other OECD economies could have highly adverse effects on developing countries, many of which are already strained by heavy debt servicing obligations. By eroding the ability of those countries to keep up their exports when the U.S. market was already getting tougher, a slowdown in Europe and Japan could exacerbate the debt crisis and threaten the liquidity of the world's private financial institutions. Even without financial instability, yet more sluggish growth outside the United States could damage confidence, causing investment to sag below its current mediocre rate. And if activity in the rest of the world fell off substantially, the improvement in the U.S. current balance projected earlier would be greatly reduced.

A growth recession abroad is not sure to happen. It is not even the most probable outcome. It is nonetheless a distinct possibility and is certainly the gravest risk now facing the world economy, threatening much more than the orderly shrinkage of the U.S. external deficit.

For completeness, we should also note the argument that a sudden steep decline in the dollar is the largest threat to world economic recovery. Subscribers to this view contend that if exchange markets become persuaded that a very large further drop in the dollar is needed for external balance, foreign holders of U.S. securities could decide that yields were insufficient to compensate them for further falls in the dollar. Because the United States will need to borrow over $100 billion a year from foreigners for the foreseeable future, an incipient drying-up of the flow of foreign funds could push up interest rates and precipitate a slowdown in the United States.

We believe that the risks of this scenario occurring are modest. But there is little need to debate which of the various unpleasant possibilities is the one to fear most. They all point to similar policy prescriptions: cooperative measures aimed at facilitating correction of imbalances while maintaining growth, particularly growth abroad.

International Policy Cooperation

A correction of the U.S. external deficit — however it is achieved — will have deflationary effects on economic activity outside the United States. It is essential, therefore, that the governments of other industrial countries acknowledge their responsibility and capacity for maintaining the growth of domestic demand in the face of that deflationary impulse. Ideally, foreign governments would go further and seek to attain somewhat higher growth rates for their real GNPs than the below-potential rates that characterized the 1982–86 period. Individual foreign countries are reluctant to initiate expansionary action on their own. They fear such actions, taken in isolation, would generate risks that outweigh any expected benefits.

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Differing views exist about the balance of risks. Foreign governments are very concerned about the U.S. budgetary situation and what it portends for inflation and currency instability in future years. The bloated federal budget deficit, the largest part of which is now structural, not cyclical, would almost certainly entail excess demand in the United States if it persisted while the external deficit was greatly reduced or eliminated. The United States needs to acknowledge that point and accept that actions by foreign governments to maintain demand abroad depend on credible further cuts in the U.S. budget deficit. No less important, foreign governments should acknowledge that rapid cuts in the U.S. budget deficit in the absence of actions to maintain demand abroad could entail world recession.

The outlines of a mutually beneficial agreement among the major industrial countries can be readily identified. Such an agreement would have five main features. First, all participating governments would commit themselves to the goal of reducing the large current account imbalances presently troubling the world economy. That means, in particular, large reductions in the U.S. deficit and counterpart reductions by those OECD countries whose surpluses are inappropriately large in relation to the size of their economies.

Second, foreign governments would agree to take timely policy actions to maintain the growth of output as external imbalances are adjusted. Third, the United States would commit itself to a change in the mix of its policies, ensuring a reduction in the size of future structural budget deficits. Fourth, the United States and other governments would announce their expectations — a "cooperative presumption" — about a lower exchange value of the dollar that they regarded as consistent with the preceding goals and policies. This presumption would be stated in the form of a broad range, not a single number. Fifth, governments would once again renounce protectionism and renew their commitment to examine trade policy problems cooperatively.

While there is something in this package that each participating government would find difficult, there are also features each should want. Many foreign governments, for example, believe that the dollar is already undervalued; they would like to discourage a further dollar depreciation. Yet the results summarized above strongly suggest that a reduction of the U.S. external deficit in combination with sustainable growth targets will require some further depreciation. This requirement cannot be avoided by cutting the U.S. budget deficit. Indeed, a reduction in the budget deficit would by itself reduce activity in the United States and thereby lower interest rates, which normally would lead to a dollar depreciation. The desired tightening of fiscal policy in the United States would therefore tend to strengthen foreign currencies, unless accompanied by a U.S. monetary contraction. Combined fiscal and monetary contraction in the United States would, however, precipitate a U.S. recession, which, on current policies, foreign economies could not withstand.

A cooperative presumption about a moderate further decline in the dollar (with understandings, perhaps only qualitative, about the currencies against which it was most likely to occur) is therefore an important part of any viable agreement. The participating governments need not make — and could not credibly do so — an absolute commitment to maintain dollar exchange rates within the ranges given by their agreement. Rather, the announced ranges would be their own rough estimate of where the fundamentals should be moving the exchange value of the dollar over the period 1987–90, taking into account the implications of their own joint policy actions.

The path of the dollar's exchange value depends critically on the other parts of the agreement. If governments agree, for example, on how much current account imbalances should be reduced, then the slower the rates of demand growth to which the Japanese and European governments can commit, the larger must be the additional appreciation of the currencies of surplus countries. If the United States restrained domestic demand growth by fiscal restriction on or near the Gramm-Rudman path, while the surplus economies targeted nominal GNP growth of not less than 5 or 6 percent, the presumptive additional dollar depreciation might be set in a range of 10 to 25 percent.

A contingent presumption of this sort about further dollar depreciation, it should be emphasized, does not imply "target zones" for exchange rates. Moreover, in the absence of agreement about rates of demand growth and the other parts of the package, it would *not* be desirable to announce such a presumption (much less imply that actions would be taken to keep exchange rates in conformity with such a presumption).

Foreign governments could take several combinations

The Paris Agreements

As this article went to press, the finance ministers of Canada, France, Japan, the United Kingdom, the United States and West Germany met in Paris February 21–22 to discuss the international economic situation. Our analysis, particularly our suggestions for greater international cooperation, have not been superceded by the decisions announced there.

Although a welcome initiative, the meeting in substance fell well short of its rhetoric on cooperation. The promised new German tax reductions are modest and will not be implemented until 1988. Japan will adopt the promised stimulative policies, if at all, only after the Diet approves the pending 1987 budget proposal, which is itself restrictive, not expansionary.

The Paris announcement that governments will "foster stability of exchange rates around current levels" could be, like the U.S.-Japanese statement of October 1986, little more than an official hope that the exchange markets will avoid further downward pressure on the dollar for the time being. If the words turn out to be underpinned by commitments to prevent further dollar depreciation, the understanding is likely to prove fragile. Reduction of the large external imbalances among the major countries cannot be attained without, eventually, further dollar depreciation. If participating governments try to stabilize exchange rates around the levels of February 1987, moreover, they may be forced to adjust their monetary policies to that external goal rather than to their output and inflation objectives — a reversal of priorities that would not, and should not, command domestic political support.

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of policy actions that would support the agreed targets. Some foreign fiscal expansion through tax cuts would be helpful. Fiscal expansion would raise demand and imports in foreign economies without necessarily leading to depreciation of foreign currencies, as foreign monetary expansion would. Many foreign governments, however, are reluctant to undertake fiscal expansion because of concern with the medium-term outlook for their public sector budget deficits.

A synchronized easing of fiscal policy abroad, if it increased real output, would not have much adverse effect on actual budget positions. Yet governments, accustomed to weighing the effect of policy changes made in isolation, are reluctant to accept that point. Many Europeans, moreover, remain pessimistic about the ability of their economies to respond to a demand stimulus with real output. The pessimism is illogical: governments do not lose sleep over the inflationary implications of export demand, so there is no reason, with export demand weakening, why they should worry about the inflationary implications of domestic demand. Nonetheless, governments' concerns about their debt positions suggest that at least part of the foreign expansion will have to come about through monetary policy.

The relative stance of monetary policies in the United States and abroad is important. The greater foreign monetary expansion is relative to foreign fiscal expansion, the easier U.S. monetary policy must be in order not to impede the necessary additional depreciation of the dollar. Monetary policies and their relative stance would have to be adjusted, depending on what exchange markets were doing and how fast the swing was occurring in current account imbalances. Declared targets for monetary policy should be conditional, with their dependency on outcomes made clear to guide public expectations.

An environment in which foreign growth was being maintained and in which the U.S. external deficit was coming down would be the best one possible in which to undertake the necessary correction of the U.S. structural budget deficit. Indeed, a credible U.S. plan of action to reduce the budget deficit is almost certainly a sine qua non for any international agreement. The governments of Germany and Japan, in particular, would not take part in any jointly agreed actions whose global consequences they considered inflationary. Bolstering demand in the rest of the world with domestic demand strong in the United States could risk inflation not too many years ahead. A shift in the balance of domestic demands between the United States and other countries is much more likely to command acceptance than a simple boost to total world demand.

Unfortunately, the government of the United States has no credibility whatever on this subject. Administration officials have responded to overseas criticism of the budget deficit since at least 1982 by agreeing with the complaints and blaming Congress. Foreign governments have not somehow failed to notice that general lip service is paid in the United States — by the White House even more than Congress — to reducing the budget deficit, while the political deadlock that perpetuates it drags on. All parts of the U.S. government care about the budget deficit a little bit but not enough to exercise courageous political leadership.

Fiscal correction in the United States will be impossible to attain without a political compromise. And some form of tax increase will be essential. Not only is that true, but foreign governments know it is true. The recent tax reform legislation and the president's preoccupation with the negative incentive effects of high income tax rates suggest that additional revenues will probably have to come from indirect taxes. The traditional approach of raising taxes on items for which demand is relatively unresponsive to price changes — for example, tobacco and liquor — has much to recommend it. Concern with energy conservation and long-run oil consumption might argue, for example, for an additional tax on gasoline (to be channeled into general revenues, not spent on more highways).

The key point is that foreign governments would find Treasury Secretary James A. Baker III more persuasive if he had a carrot to offer as well as a stick. A credible plan for a tax hike in his back pocket would be a stronger negotiating chip than thinly veiled threats to let the dollar slide. Furthermore, the tax rise would be easier to sell to domestic political constituencies in the United States if it were part of an international agreement in which other governments were committed to doing their share.

An international agreement along these lines is economic common sense, but a house of cards politically. No part stands on its own; the package can only be drawn up and implemented if each major country agrees to make its contribution. If a player holds out or withdraws one of his cards, the whole edifice would come fluttering down.

The imagination and will required for international agreements, and the sheer hard work of crafting the details, tend to be mustered only in times of crisis. Although the dangers currently facing the world economy are real, statesmen and bureaucrats are not yet frightened enough to take constructive action. If the situation begins to deteriorate, we must all hope that their capacity for fright and foresight measures up to the imperious needs of the times.

"Fiscal correction in the United States will be impossible to attain without a political compromise."

* The imbalance in the current account of the balance of payments — what we call the external deficit — includes the transactions in goods, services, investment income, and transfer payments between U.S. residents and foreigners. The largest part of the current account deficit is the trade deficit (the shortfall of merchandise exports below merchandise imports).

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The Investment Climate in China

Harry Harding

THE PEOPLE'S REPUBLIC of China is redoubling its efforts to attract foreign investment. Last fall, largely in response to increasingly vocal criticism from foreign investors about the difficulties and costs of doing business in their country, Chinese leaders announced a series of wide-ranging measures intended to increase investment incentives. A sincere attempt to address many of the concerns most frequently raised by overseas businessmen, these regulations are nonetheless both incomplete and vague. Their effectiveness will depend on how they are implemented and on whether they are followed by additional measures to improve China's investment climate.

More important, the new regulations make clear that China continues to favor foreign investment projects that will introduce new technology or increase Chinese exports. Projects that meet these criteria will be given preferential treatment. In contrast, projects that seek to produce principally for the domestic Chinese market or that provide China only with ordinary levels of technology will probably find that Chinese conditions remain relatively inhospitable. Unfortunately for both the Chinese government and the potential foreign investor, it is precisely these kinds of projects that the international business community is most eager to launch in China.

Expectations Unfulfilled

Encouraging foreign investment, particularly from the United States, is one of the principal objectives of China's current foreign economic policy. Foreign investment projects can help furnish, in a single, well-integrated package, many of the resources that China seeks to obtain from the international economy. First, direct foreign investment augments China's domestic sources of investment capital, and provides it in the form of foreign exchange. Second, foreign investment is a vehicle for bringing advanced technology into China and for ensuring that Chinese managers and engineers learn how to use it. And third, foreign investment projects help China to produce goods better-suited for world export markets and to sell those goods through established international marketing channels.

Attracted by these potential benefits, Chinese leaders have adopted increasingly accommodating policies toward foreign investment since the death of Mao Zedong in 1976. At first, Peking appeared to have identified the equity joint venture as the organizational form that most foreign investment should take. Over time, the Chinese have become much more flexible, welcoming a variety of alternative legal formats ranging from wholly foreign-owned enterprises to contractual joint ventures of various sorts. (Throughout this article, the term "foreign venture" refers to all types of enterprises with foreign investment.) Similarly, Peking originally sought to attract foreign investment primarily to the

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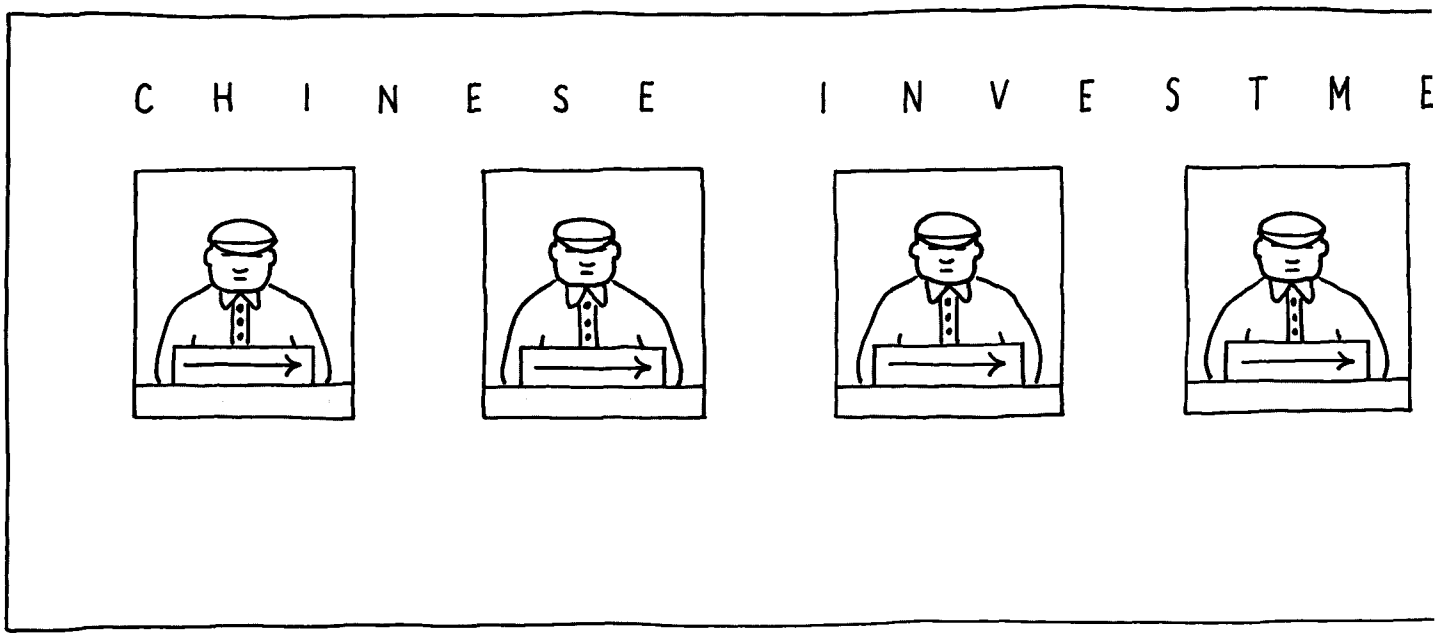

four special economic zones established along the coast of Southeast China in 1980. Gradually, however, the Chinese have opened the rest of the coastal areas, and even some inland provinces have launched their own promotional schemes to attract foreign investment.

During the earlier period, when policies toward foreign investment were more restrictive, the level of direct foreign investment in China remained relatively low. Although foreigners signed agreements between 1979 and 1983 for projects totaling about $7.5 billion, they actually invested only about $480 million during that period. But as Peking diversified the organizational forms that foreign investment could take and opened more parts of the country to entrepreneurs from abroad, the level increased rapidly. The amount of overseas capital absorbed in foreign ventures during 1985 rose to $1.87 billion, more than double the amount invested during 1983.[1]

Nonetheless, the pace of investment was still not fully satisfactory to Peking. Although the Chinese have never announced any explicit targets, there is every reason to believe that the $4.6 billion invested in their country between 1979 and 1985 fell short of their original expectations. Moreover, the nature of the projects has been disappointing. The majority have been small enterprises, launched by overseas Chinese from Hong Kong, with low levels of capitalization and relatively unsophisticated technology.

The expectations of the foreign business community were not fulfilled either. The misgivings that many foreigners have about investing in China can be attributed to a number of chronic problems: the high cost of many important inputs, especially land, housing, labor, and office space; the relatively poor training and discipline of Chinese workers; the low quality of Chinese components; the uncertain availability of some raw materials and loans in Chinese currency (*renminbi*); an incomplete legal system; an overburdened communications and transportation infrastructure; and convoluted lines of authority within the Chinese bureaucracy. Doubts also persist about the long-term stability of the Chinese political system — doubts that have been exacerbated by the student protests at the end of 1986 and the dismissal of Party General Secretary Hu Yaobang in January 1987.

Above all, because the Chinese have required each foreign venture to maintain its own foreign exchange balance, it has been difficult for foreign ventures to repatriate any profits not earned in hard currency. With only a few exceptions, the export of profit has been permitted only if it is counterbalanced by a compensating inflow of foreign exchange through exports or new investment. This restriction has discouraged foreign firms from investing in projects whose main purpose is to tap the domestic Chinese market.

The Crisis of 1986

These chronic problems suggested to many overseas businessmen that China, for all its rhetoric, did not truly welcome foreign investment except on exploitative terms. Then, in 1985 and early 1986, some additional developments compounded these long-standing difficulties. The Chinese economy was seriously overheated during that period, with excessively high levels of domestic investment and equally high wage bills. The result was a surge of imports of capital equipment and consumer goods, uncompensated by a corresponding increase in exports. China's commodity trade experienced a $15 billion deficit in 1985, which in turn caused the country's foreign exchange reserves to drop from $16.7 billion at the end of 1984 to $10.3 billion at the beginning of 1986. To remedy the situation, the central authorities tightened their control over the expenditure of foreign exchange, which made it difficult for all Chinese enterprises, including foreign ventures, to import necessary equipment or components. In July 1986, the government also devalued the Chinese currency by about 16 percent, from 3.2 *yuan* to the dollar in 1985 to 3.7 in 1986.

These remedial measures caused considerable hardship for several prominent foreign ventures, including both the Beijing Jeep Corporation and Shanghai-Volkswagen.

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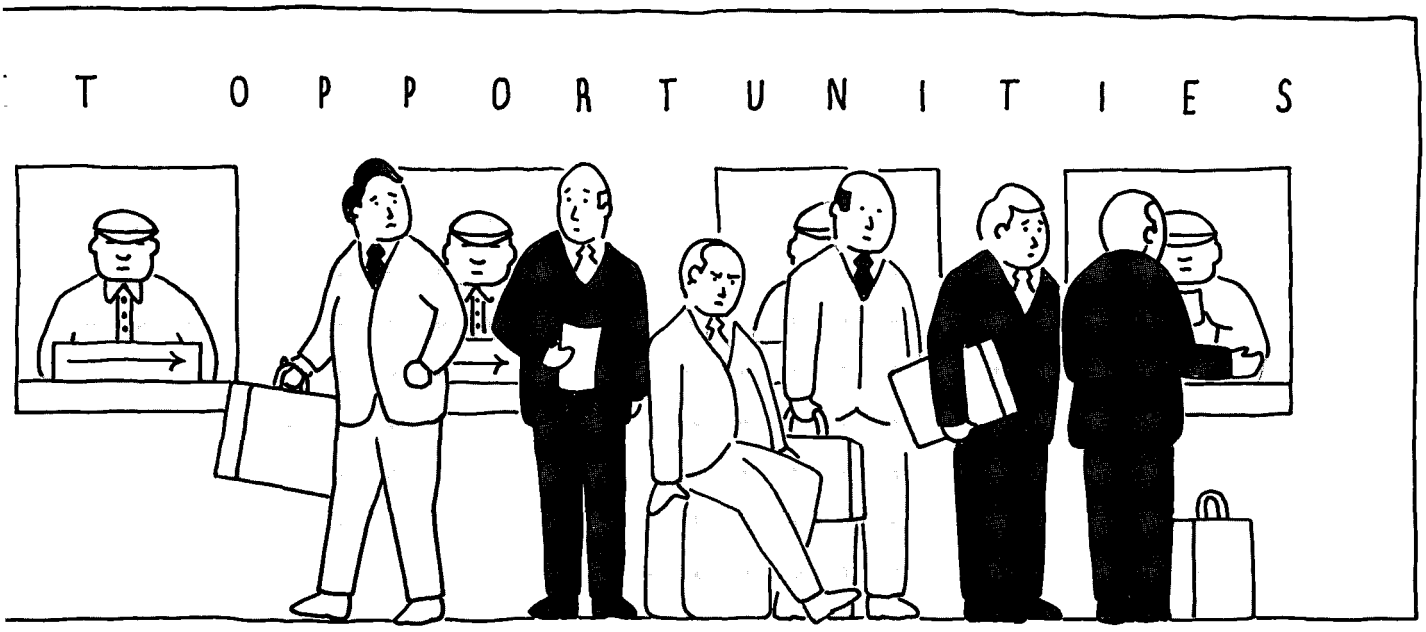

These foreign ventures had planned to assemble vehicles of foreign design inside China, using a mix of imported and domestic components. But technological problems prevented them from utilizing local components as rapidly as they had anticipated. At the same time, the devaluation of the *yuan* increased the cost of importing components from abroad and thus raised the price of the finished product on the Chinese market. Because of the tighter controls over foreign exchange, foreign ventures in some cases could not obtain hard currency with which to purchase foreign components, nor could potential Chinese buyers pay for the resulting goods with foreign exchange certificates.

The accumulation of difficulties generated growing pressure on China to improve its investment climate. The commercial section of the American Embassy in Peking drew up a model joint venture, outlining the changes in infrastructure, market access, living conditions, and legal framework that would be necessary if foreigners were to continue to find investment in China an attractive proposition. And in a major speech delivered in Washington on May 28, the U.S. ambassador to China, Winston Lord, noted that the American business community was "frustrated by high costs, price gouging, tight foreign exchange controls, limited access to the Chinese market, bureaucratic foot-dragging, lack of qualified local personnel, and unpredictability."

These statements of dissatisfaction were echoed in even stronger terms by the business community and the press. In April, articles in the *New York Times* and the *Washington Post* portrayed the difficulties that American Motors was experiencing with Beijing Jeep as symptomatic of the general problems encountered by foreign investors in China. Later that same month, the International Businessmen's Association of Peking wrote to George Bush warning that, if the Chinese business climate did not improve, American firms might begin to withdraw their investments.

By early August the concrete effects of this negative publicity had become amply apparent. The Chinese themselves announced that new overseas investment in the country had fallen 20 percent in the first six months of the year, reflecting a growing crisis of confidence in China's suitability as a site for foreign ventures.

The New Regulations

Although the Chinese are not eager to admit it, most foreign observers believe that the outside pressures had a considerable effect in persuading Peking to take action. In the early summer, Chinese leaders began considering the steps that would be required to restore the trust and good will of overseas investors. In the course of their deliberations, they made a sincere effort to gain a better understanding of the complaints and requirements of foreign businessmen. They did so not only by requesting Chinese specialists on international economics to conduct research on the attitudes of the foreign business community, but also by arranging meetings between overseas investors and high-ranking Chinese officials, including both Zhao Ziyang and Deng Xiaoping.

On October 11, the State Council issued a set of "Provisions for the Encouragement of Foreign Investment," familiarly known as the "Twenty-Two Articles."[2] Shortly thereafter, several provincial and municipal governments, particularly along the coast, announced additional regulations to encourage greater foreign investment in their localities.[3]

Essentially, the measures offer four sets of incentives. First, they are supposed to reduce the cost of conducting business in China by lowering taxes, land use fees, wage rates, and the cost of water, electricity, transportation, and communications. Second, the regulations promise improved access to crucial inputs controlled by the state, including raw materials, transportation and communication facilities, and loans in local currency. Third, the regulations are intended to increase the efficiency with which the bureaucracy approves or rejects foreign investment projects, in part by establishing deadlines for government action. Finally, the regulations guarantee foreign

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ventures greater autonomy with regard to production plans, imports and exports, the wage and salary system, and the employment and dismissal of labor. The central provisions, for example, promise foreign ventures the right to "determine their organizational structure and personnel system, employ or dismiss senior management personnel, and increase or dismiss staff and workers." They also give enterprises the right to recruit new workers directly and urge the units to which the new recruits were previously assigned to "permit their transfer."

While all foreign investors should benefit from the provisions, the regulations establish two categories that will enjoy particularly favorable treatment. The first, classified as "export enterprises," are those enterprises that, through exports, produce a favorable balance in their annual foreign exchange accounts. The second category, known as "technologically advanced enterprises," are those that use equipment provided by foreign investors to manufacture new products, improved products, or products that would otherwise be imported. In this way, the new regulations have underscored Peking's preference for investment projects that will pay for themselves through exports or that will provide China with relatively advanced technology from abroad.

Questions Unanswered

Chinese leaders say that the regulations are intended to improve the investment "micro-climate" *(xiao qihou)*. In fact, it is becoming more and more difficult to speak of a single "investment climate" in China. Not only does the climate vary with the type of project that the overseas businessman has in mind, it varies from city to city and from region to region, with the coastal areas still able to offer more to foreign investors by way of physical infrastructure, tax advantages, and the quality of labor, government, and management. Chinese officials claim that, as a result of the new regulations, the investment opportunities in this part of China now compare favorably with other countries and regions in Asia. But how do outside observers evaluate them?

To begin with, a great deal will depend on how the regulations are interpreted and implemented. Some important questions that must be answered include:

— How much autonomy will the enterprises actually enjoy in labor matters? Given how difficult it is for Chinese firms to discharge nonproductive employees, how free will foreign ventures actually be to dismiss workers whose performance is not up to standard?

— Will the new agencies designed to expedite the establishment of foreign ventures and to improve their access to state-controlled raw materials serve as facilitating bodies? Or will they simply be another layer of bureaucracy?

— Will the exemption of foreign ventures from the payment of certain subsidies and from the wage ceilings set by some local regulations actually reduce labor costs in China to a level competitive with other Asian countries?

— How will foreign ventures be certified as technologically advanced or import-substituting enterprises and therefore eligible for preferential treatment? Will the criteria be lenient or stringent? Will these classifications be assigned permanently, or must they be renewed periodically? Chinese authorities will be under substantial pressure from China's own industries to restrict the access of foreign ventures to the domestic market, and it is in this area that protectionist sentiment is especially likely to be manifest.

A committee, headed by State Councillor Gu Mu, has been established to draw up more detailed regulations that may answer some of these questions. That committee is supposed to complete its work by the end of March. Indeed, a new set of labor regulations for foreign ventures has already been issued, as have provisions concerning the extension of *renminbi* loans by the Bank of China. Once such detailed regulations have been promulgated, their implementation will still depend on the actions of lower-level central bureaucrats and local authorities, who do not necessarily share their superiors' enthusiasm for the facilitation of foreign investment in China.

"Chinese officials claim that, as a result of the new regulations, the investment opportunities in this part of China now compare favorably with other countries and regions in Asia. But how do outside observers evaluate them?"

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Problems Unaddressed

Even if they are interpreted fairly and implemented effectively, the regulations issued last autumn touch on but a fraction of the problems encountered by the foreign business community. The Twenty-Two Articles, for example, ignore four areas covered by the American embassy's model joint venture, including the development of China's physical infrastructure, the amelioration of living conditions for expatriate managers and employees, the further elaboration of the legal system, and the establishment of a right of direct appeal to the State Council on disputes regarding foreign ventures. Nor do they help improve the quality of the raw materials, components, labor, or managerial personnel needed by foreign projects.

Moreover, on one crucial issue, the Chinese have explicitly rejected the advice of their overseas partners. For foreigners, two principal attractions are access to the large Chinese domestic market and the right to convert the resulting profits into foreign exchange for repatriation. Thus, the American embassy recommended that foreign ventures have the "right to sell to the domestic market" and the corresponding "right to repatriation of profits within 30 days of application." But the Twenty-Two Articles continue to reflect a conservative approach to the question of repatriation of profits. In general the Chinese still expect foreign ventures to generate, through exports, the foreign exchange with which to remit any profits earned in *renminbi*.

At present there are only a limited number of ways to circumvent this general rule. The Chinese allow foreign ventures with the same overseas investor to pool their foreign exchange, so that the surplus earned by one enterprise can be transferred to one with a deficit. Peking also encourages the use of countertrade to solve the repatriation problem: it recommends that foreign ventures producing for the domestic market use their profits to buy Chinese goods for export abroad. Enterprises whose products are officially classified as import substitutes may require their Chinese customers to pay at least a portion of the price in foreign exchange.

Intriguingly, the new central regulations also formally endorse the creation of a rudimentary market in foreign exchange, in which foreign ventures may sell surplus hard currency for a premium to foreign ventures that are experiencing a shortage. These transactions, however, must be supervised by a newly established agency, charged with ensuring that the exchange rate is acceptable and that the purchase of foreign exchange is for an approved purpose. Moreover, early accounts of the market's operation in Shanghai have not provided any explicit assurances that repatriation of profits earned in *renminbi* — as opposed, say, to the import of necessary equipment and materials from abroad — will be an approved purpose.

Despite these few exceptions, the general principle is clear. The Chinese want to maintain a national balance of payments, and they expect each foreign venture to do so as well. They are therefore willing to provide only limited opportunities for the conversion of *renminbi* profits into foreign exchange.

If they were to open their domestic market to foreign investors, the Chinese fear that the resulting demand for the repatriation of profits would cause a hemorrhage of the country's scarce foreign exchange. They point out that foreign ventures already run an aggregate foreign exchange deficit, in that the hard currency they earn from exports is less than the foreign exchange they use to import foreign components and equipment.[4] Permitting the repatriation of profits earned in *renminbi* would represent an unacceptable additional claim on China's foreign exchange earnings and reserves.

"Even if they are interpreted fairly and implemented effectively, the regulations . . . touch on but a fraction of the problems encountered by the foreign business community."

The Chinese have legitimate grounds for concern. But many foreign observers consider Peking's approach to be overly conservative. Opening China's domestic market to foreign ventures would increase the amount of overseas capital invested in China and possibly the rate at which foreign entrepreneurs reinvest their profits in China. The effect would be to increase the flow of foreign exchange into the country and reduce its outflow.

Equally important, competition from foreign ventures would help stimulate the productivity and efficiency of China's own industry, which in turn might also boost the PRC's competitiveness in world export markets. Indeed, the reason why the Chinese restrict access to their internal market may have as much to do with protecting inefficient domestic enterprises against competition as with preserving the nation's foreign exchange reserves.

Foreign reaction to Peking's new investment incentives has been cautious at best, and skeptical at worst. Officials in the American embassy in Peking have said that they had expected more comprehensive steps. The director of the Peking office of the National Council for U.S.-China Trade has said that the new regulations are like half a sundae: a "really good cherry and whipped cream, but no ice cream." And the head of the Japan-China Economic Law Center has pointed out that the kind of foreign ventures the Chinese hope to attract — particularly technology-intensive enterprises — do not have much chance of success given the country's poor infrastructure.

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These characterizations may be a bit harsh. They understate the significance of the reduction of the cost of doing business in China and the increase in the managerial autonomy of foreign ventures. But the fact remains that the new regulations are incomplete. Chinese leaders have said that the regulations represent only the first step in encouraging foreign investment. Foreign businessmen are waiting to see what the next steps will be.

The Macro-Climate for Investment

Overall the conditions for foreign business in China cannot be divorced from the general progress of economic and political reform in the country. To a degree Chinese leaders can create a "micro-climate" favorable to foreign investment. But the context for investment in China will also depend upon the broader "macro-climate" in which all enterprises, both Chinese and foreign, must operate.

Chinese leaders have been showing increasing willingness to adopt difficult and potentially controversial measures that are key to the success of the urban economic reforms announced in 1984. Peking has moved to adjust prices to more rational levels, to reform the labor and wage systems, and to impose greater financial discipline on Chinese enterprises by instituting bankruptcy laws and similar measures. While progress has been apparent, it has also been slow. Furthermore, the recent student demonstrations and the resulting dismissal of Hu Yaobang have created an extremely cautious and tentative mood among Chinese leaders. There remains the strong possibility that further price reforms will now be delayed and that the implementation of the new bankruptcy and labor laws will be postponed.

In addition, the success of the urban economic reforms depends on difficult decisions in the political realm, particularly the problems of reducing the authority of both the Communist party and the state over economic enterprises. So far, Chinese reformers have issued regulations and directives that order party secretaries and bureaucratic officials to relax their control over enterprise managers. More drastic measures may be required, including reforming the system of ownership of state enterprises, restructuring the state bureaucracy responsible for economic affairs, and even abolishing the party committees within individual enterprises. Some experiments are being undertaken on the first two issues, and some Chinese have been talking privately about the third, but it is not yet clear whether they can obtain party support and approval on a national basis. Indeed, the recent student protests have diminished the immediate prospects for this new wave of radical and economic reforms.

Even if the reforms maintain their momentum, they could, paradoxically, complicate as well as facilitate the work of foreign ventures in China. Price reform will create a more rational economic environment, but it may also cause the price of subsidized raw materials to rise considerably. Decentralization will relax the control of the central ministries over the economy, but it may also place regulatory power in the hands of a new group of inexperienced local officials and blur the division of power between central and local authorities. When the new bankruptcy law is implemented, the Chinese government will no longer be responsible for the debts of state enterprises, and foreigners will have to make more careful investigations of the creditworthiness and economic health of potential Chinese venture partners. Similarly, changes in the system of state ownership will ultimately give Chinese managers greater autonomy in running their enterprises but, in the short run, create considerable uncertainty over who is responsible for the decisions on the Chinese side of joint ventures.[5]

In short, the Chinese investment climate is slowly improving. Some projects, particularly those in categories to which Peking has assigned high priority, will be successful. But the process is slow and incomplete, and it is not yet clear whether China will ever choose to extend an unconditional welcome to foreign investors who seek to produce for the domestic market.

"These characterizations may be a bit harsh. They understate the significance of the reduction of the cost of doing business in China. . . ."

1. The data on the amount of foreign investment actually absorbed in China remain highly problematic for the years before 1984. The figures given here are calculated from *Beijing Review,* February 10, 1986, p. 28; and *1986 China Statistical Handbook* (Washington, DC: Rock Creek Research, 1986), p. 22.

2. For the text of the central regulations, see *Beijing Review,* October 27, 1986, pp. 26–28. For analysis, see Jerome Alan Cohen and Ta-kuang Chang, "The New Foreign Investment Provisions," *China Business Review,* 14:1 (January–February 1987), pp. 11–14.

3. Local regulations were announced in 12 provinces, 12 cities, and all four special economic zones. For a list, see *China Business Review,* 14:1 (January–February 1987), p. 18. For a brief summary of some of these provisions, see *Far Eastern Economic Review,* November 6, 1986, p. 84.

4. A survey of foreign ventures in 19 key provinces in 1985 revealed a total net deficit of $580 million, one half of which occurred in Guangdong province alone. According to the survey, $1.28 billion in imported parts and equipment was counterbalanced by only $228 million in new foreign investment and $472 million in exports. *South China Morning Post,* July 16, 1986, in *Foreign Broadcast Information Service Daily Report: China,* July 17, 1986, pp. U4–U6.

5. Indeed, in at least one instance, changes in the ownership system have meant that the Chinese partner in a foreign venture has been formally dissolved, with no successor enterprise identified to take its place.

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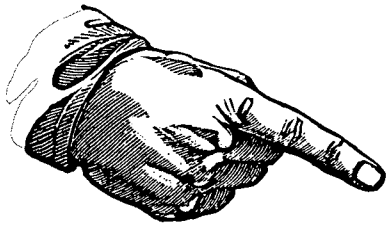

The Politics of Blame

R. Kent Weaver

ONE OF THE MORE INTERESTING aspects of the secret sale of arms to Iran is the impact the revelations have had on President Reagan's popularity. In one month the percentage of Americans who approved of his job performance fell by 21 points. For most other presidents in similar circumstances, this plummet in popularity would not have been surprising. But Reagan has not been a typical president. For nearly six years he has been labeled the "Teflon president" because no failure or scandal in his administration seemed to stick to him personally.

The Teflon presidency was no accident, however. Reagan's personality has been a major asset in deflecting blame. But it has been buttressed by a series of careful strategic choices, including a willingness to sacrifice policy objectives when the political costs become too high. Reagan's actions on Social Security clearly illustrate this strategy. In 1981, after his administration's proposal to make drastic cuts in some Social Security cost-of-living allowances drew a storm of protest, Reagan quickly disassociated himself from it. The president was much more cautious at the beginning of his next term, saying that he would accept cuts in Social Security adjustments only if overwhelming bipartisan majorities in Congress took the initiative — that is, if others took most of the blame. When senators from his own party took the lead in proposing a budget plan that included a freeze on Social Security allowances, Reagan refused to endorse it.

Legislators and bureaucrats as well as presidents try to minimize blame. Enactment of the Gramm-Rudman-Hollings budget-cutting process is a classic example of legislative blame-avoidance at work. Despite deep reservations many legislators voted for the measure because they did not want to be seen as "soft on the deficit." The procedure itself (later overturned by the Supreme Court) was a blame-minimizing one: it provided for automatic across-the-board spending cuts, eliminating the need for legislators to vote for them.

Into every politician's life more than a little blame will fall. While politicians may act for any of several reasons — notably the desire to make good policy — the deftness with which they avoid or deflect blame is probably the most important determinant of whether they remain in public office. This article looks at the kinds of situations that generate blame, outlines the strategies politicians — particularly legislators — use to avoid or minimize it, and explores the effects of blame-avoiding behavior on public policy.

R. Kent Weaver is a research associate in the Governmental Studies program at Brookings. He is completing work on a book, Automatic Government: The Politics of Indexation, *from which this article is adapted.*

What Have You Done to Me Lately?

The decisions politicians must make fall generally into one of three categories. In some situations they can claim credit with their constituents or potential campaign contributors while running only a slight risk of incurring blame.

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"Today voters are likely to return the incumbent unless they are given a reason not to. . . . Thus incumbents must avoid giving their opponents a popular election issue."

"Casework" — helping a constituent get an overdue Social Security check, for example — and voting for "pork barrel" projects in the home district are two such opportunities for legislators. Both are almost pure political profit. In other cases lawmakers may face no external pressures at all. They can, therefore, vote their own policy preferences or trade their support on an issue for another politician's support on a matter of interest to themselves or their constituents. An urban legislator, for example, may trade his vote on a farm issue for a farm legislator's vote on an urban measure.

On issues like abortion and school prayer, however, any decision that a politician makes is likely to please some constituents but anger others. Legislators motivated primarily by electoral considerations will presumably choose the option that maximizes constituency support. But that is not a simple calculation to make. Even if polling data is available, a politician may not accurately gauge whether constituents will actually change their vote because they agree or disagree with the politician's position.

Politicians must also take into account what political scientists call the "negativity bias" of voters. Individuals who suffer losses as a result of an officeholder's action are more likely to notice the loss, to feel aggrieved, and to act on that grievance than those who benefit are likely to act on the basis of their improved state. In short, voters are more sensitive to what has been done *to* them than *for* them.

Gun control is a classic illustration of negativity bias. Because many opponents of gun control will vote against a legislator solely because he supports stricter gun laws, they are able to exert extraordinary influence on the issue. Interest groups have also discovered that they can use negativity biases to raise funds for specific causes and candidates. By centering their appeal on the danger posed by a specific "devil figure" such as Senator Jesse Helms or actress Jane Fonda or by the loss of some benefit or right such as Social Security benefits, they can focus blame and give their members an immediate way — sending funds — to air their grievances.

Putting Politicians on the Spot

Given voters' negativity bias, it is not clear that an action that benefits a majority of a politician's constituents at the expense of a minority is a wise political choice. The losers are more likely to punish than the gainers are to reward. The politician's best option may be to avoid having to take a stand altogether. But a number of recent changes — notably in the economy and fiscal climate, in political campaigning, and in congressional procedures — have increased blame-generating pressures on politicians.

High budget deficits have limited opportunities for new spending and heightened competition among federal programs for the funding that is available. Legislators can no longer act as if decisions in one segment of the budget have no effect on other segments. The Gramm-Rudman-Hollings budget initiative is an obvious and very important manifestation of this phenomenon.

The decline of the influence of political parties on candidates has also been a factor. Incumbents have responded to party decline by establishing their own individual identities and distancing themselves from party positions that their constituents might not support. Today voters are likely to return the incumbent *unless they are given a reason not to.* Incumbents know this, and their potential opponents know it. Thus incumbents must avoid giving their opponents a popular election issue. The advent of negative advertising has made it easier for challengers to generate blame. Simple negative images, televised repeatedly, can undermine voter confidence in the incumbent, reinforcing the officeholder's reluctance to vote against positions likely to appeal to poorly informed constituencies. Interest groups and political action committees are also more sophisticated at monitoring officeholders' behavior, targeting funds, and generating blame.

Political and procedural changes have stimulated blame-generating behavior within Congress. Legislators are no longer dependent on party apparatus or funding to win election. The decline of the seniority system and the growth of formula funding for federal grant programs make junior members considerably less dependent on the largesse of more senior members to win benefits for their districts. Consequently members are less likely to forgo credit-claiming opportunities that require them to force blame-generating choices on their colleagues. Members who decide that they stand to gain politically by insisting on a vote to kill a congressional pay raise or to ban federal funding of abortions are more likely than they once were to put their colleagues on the spot.

At the same time, a series of reforms has undercut the ability of congressional leaders to keep blame-generating issues off the legislative agenda. Rules changes enacted in the 1970s make it easier for House members to gain floor consideration of amendments. The institution of recorded

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teller votes in the House in 1970 followed by electronic voting in 1973 has dramatically increased the number of issues on which representatives are forced to record their position publicly.

Don't Blame Me

Policymakers can respond to blame-generating pressures in several ways.

1. Control the Agenda. The best way to keep a blame-generating issue from hurting politically is to keep it off the agenda in the first place. In the battle over the 1981 budget reconciliation bill in the House of Representatives, for example, the Democratic leadership tried to force separate floor votes on five sections of the bill. As David Stockman wrote in *The Triumph of Politics,* their intent was to make Republicans and Boll Weevils "vote against food stamps and Medicaid and Social Security, out loud and one at a time." The administration and House Republicans outmaneuvered the Democrats, winning a rule that allowed only a single up-or-down vote on the entire package. This strategy allowed legislators to vote for an overall budget cut without having to take the heat for voting to cut individual programs.

When a blame-generating decision cannot be kept off the agenda completely, lawmakers can often influence when they must confront it. They might, for example, refer controversial issues to a study commission with instructions to report after the next election.

Once an issue has made it on to the agenda, policymakers use several strategies to avoid or minimize blame.

2. Redefine or Obscure the Issue. Policymakers may be able to neutralize a blame-generating issue by reshaping it. If an issue divides two industries, policies may be devised so that each industry obtains satisfactory outcomes, while costs are spread more broadly. Or lawmakers may try to obscure the issue by couching it in arcane legislative language or burying it in a larger measure. Legislators may also take a series of votes rather than just one on controversial issues to soften or obfuscate their position.

3. Throw Good Money After Bad. When all possible alternatives involve constituent losses, or when policies clearly have failed, legislators may recognize they cannot escape eventual blame. But they may try to delay the inevitable by committing extra resources to shore up the status quo. This pattern can be seen in the debate over storage of high-level radioactive wastes from nuclear power plants. Funds continue to be spent to expand "temporary" storage facilities at power plant sites because no state wishes to host a permanent disposal site. A first site for a repository is unlikely to be named until 1990 or opened before 1998 — 16 years after passage of the act that set up a selection process.

4. Pass the Buck. If a blame-generating decision must be made, policymakers are likely to try to delegate that decision to someone else. In addition to delaying site selection of permanent nuclear waste storage sites, Congress has also dumped much of the selection process in the president's lap. Congress delegates to independent regulatory commissions responsibility for many of the most sensitive economic conflicts that pit one company's or industry's interests directly against others (e.g., mergers, rate-making).

"The best way to keep a blame-generating issue from hurting politically is to keep it off the agenda in the first place."

5. Find a Scapegoat. If a politician cannot pass the buck for an unpopular decision, he may be able to pass the blame for it instead. The usual tactic is to claim that your actions were necessitated by the actions of your predecessors: President Reagan, for example, has claimed that austerity measures were required because of profligate spending by past Democratic administrations.

Scapegoating can also be useful when past scandals or policy gaffes are discovered. President Reagan has been able to use his decentralized management style to deflect blame to his subordinates on many occasions. The limits to his use of this strategy appear to have been surpassed only in the Iran arms imbroglio; many who believe the president did not know fully what was going on fault him for not having exercised more control over his staff.

6. Jump on the Bandwagon. On issues where politicians know their views differ from their constituents, they may be able to switch sides unobtrusively — to jump on the bandwagon — when it becomes evident that other strategies (notably agenda control and redefining the issue) have failed. If a legislator's original position has not been publicized, he may even be able to claim credit for holding the popular position all along. This desire to turn blame into credit helps explain why seemingly unimportant procedural votes are in fact often more important than final votes on passage. A procedural vote, which may escape close public attention, can reveal the balance of forces. Once it is clear which side is likely to win, legislators, seeing little purpose in continuing to support

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the losing side, may switch their vote on final passage.

A clear example of failed agenda limitation followed by a bandwagon effect can be seen in the 1986 House debate on an omnibus drug bill. Liberal Democrats were opposed to a series of Republican amendments that would require military participation in anti-drug efforts, limit the application of the "exclusionary rule" on illegally seized evidence, and permit imposition of the death penalty in some drug cases. But with an election fewer than eight weeks away, they could not afford to appear "soft on drugs." After the Democratic leadership failed to stop the amendments from coming to the floor, many Democrats capitulated to election pressures and supported the amendments. Only 16 representatives voted against final passage of the bill despite inclusion of all the Republican amendments.

7. Circle the Wagons. Based on the same principle — safety in numbers — as the jump-on-the-bandwagon approach, this strategy may be used when there is no way to avoid imposing losses on some or all constituents. The idea is to arrive at a consensus solution that provides political cover for everyone, making it difficult for a future political opponent to raise the issue. When it works best, this approach may even yield political dividends: the decisionmaker may be credited with taking the hard, gutsy stand (which everyone else is taking as well).

Circling the wagons is risky, however, because it works only if near unanimity can be maintained. Participants may be sorely tempted to defect from the consensus if they see an opportunity to shift the blame to others and claim credit for resisting the loss-producing solution. Unless an agreement can be negotiated quietly, with commitments of support made before it is announced, the strategy is unlikely to succeed. The White House encountered precisely this situation in attempting to win support for the package negotiated in 1983 to alleviate the financial crisis in the Social Security system. If opposition to the package (which, because it cut benefits and raised taxes, pleased no one) achieved a critical mass, its broad but very thin congressional support could have dissipated very rapidly.

8. Stop Me Before I Kill Again. Legislators are not, as has been noted, single-minded seekers of reelection; they are also likely to have preferences for "good policy." Sometimes politicians must choose between a politically popular position — a credit-claiming opportunity — and what they believe to be a responsible policy position. If policymakers are simply credit-claimers, they will sacrifice their policy preferences, jump on the bandwagon, and support the politically popular position. If they can limit their own discretion, however, they may be able to achieve their policy preferences without risking their political future, just like a criminal, by turning himself in, can keep himself from taking actions he knows are wrong but cannot resist.

Fiscally conservative Republican legislators found themselves in this situation during the late 1960s and early 1970s, as they confronted Democratic initiatives in Congress to raise the real as well as nominal benefit levels for Social Security through ad hoc increases. These fiscal conservatives thought that the benefit changes were bad policy but found a vote against the increase very difficult to explain to their constituents. In a time when reliance on ad hoc changes was perceived as leading to higher real benefits, indexing benefit increases to increases in the cost of living offered a way to make a benefit freeze politically palatable — it reconciled "good policy" objectives with blame-avoiding ones. Many proponents of constitutional limits on government expenditures use a similar logic; they contend that a constitutional requirement to balance the budget is the only way to force legislators to collectively exercise spending restraint, since none of them wishes to vote against individual spending programs.

"Blame-avoiding behavior also helps to explain why policies are so difficult to change even when they have failed."

Effects on Policy

The analysis outlined above suggests that blame avoidance may lead to the adoption of policy alternatives that otherwise might fail. In this sense alone, it has an important impact on policy, if only the passive one of influencing choices made from among a set of alternatives determined by "good policy" advocates and credit-claimers. But blame also affects the alternatives considered.

The limitation of policymakers' discretion through indexation, formula grants, merit hiring, and other more or less automatic mechanisms is the foremost example. Blame avoidance can help to produce discretion-reducing decisions in three ways. First, policymakers may seek to curb their own discretion if the exercise of that discretion offers few credit-claiming opportunities and high prospects for blame. Gramm-Rudman is a recent manifestation of this phenomenon: discretion to cut popular spending programs is not the kind of discretion that astute politicians wish to exercise. Reduction of discretion is, in short, a way to pass the buck.

Even where discretion has credit-claiming potential, its exercise may be risky. In choosing whether to maintain discretion over any program, legislators must consider that they might lose benefits for their constituents when the program comes up for renewal. Furthermore, political opponents may be able to score points by claiming that they could have gotten the voters a better deal — a claim that is harder to make if the benefit is raised automatically.

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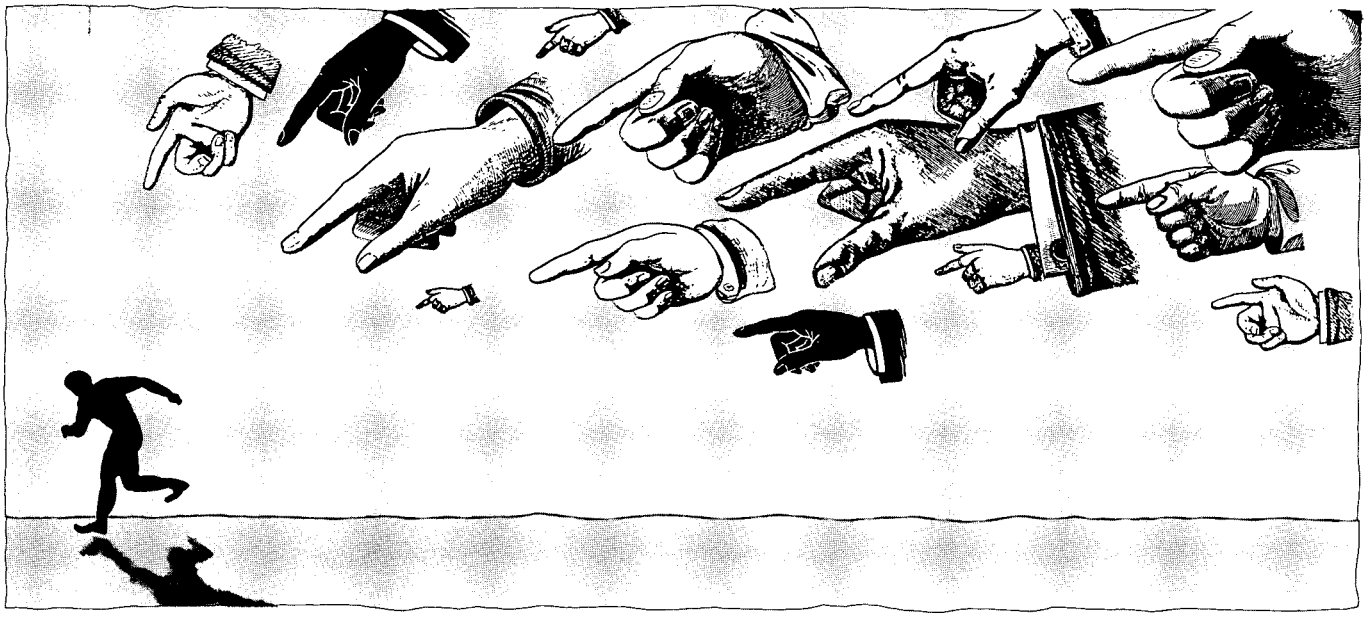

Legislators must also consider whether the time and resources used to influence these allocation decisions might be better spent on matters with less blame-generating potential. Forgoing discretion is likely to be the politically safer response.

Second, policymakers may wish to maintain discretion, and thus credit-claiming opportunities, but be forced to give it up when critics mobilize opposition to its exercise. The elimination of patronage when it became an issue of "good government" is an example. Here loss of discretion followed from a jump-on-the-bandwagon mentality.

Finally, policymakers may come to favor a reduction of discretion in situations that force them to make unacceptable choices between obtaining substantial credit but very bad policy, on the one hand, or incurring substantial political blame, on the other. The support of conservative Republicans for Social Security indexation as a way to avoid having to vote either for or against real benefit increases was noted earlier as an example of this "stop me before I kill again" strategy for reducing discretion.

Blame-avoiding behavior also has important implications for interest group power. Policymakers often urge competing interest groups to work out their differences and arrive at a consensus position that the policymakers can then endorse. This strategy limits officeholders' ability to claim credit for reaching the agreement, but it minimizes the risk of offending one or the other of the groups. It also allows private organizations to make public policy and obscures the lines of accountability.

But blame-avoiding behavior places natural limits on interest group "capture" of governmental institutions. Even if an interest group is normally the only "attentive public" for a regulatory agency or a congressional committee, those government bodies know that if they go too far to accommodate that interest, they run the risk of mobilizing latent opposition or traditional governmental checks — that is, of being blamed. Regulatory agencies can have their decisions overturned by the courts, for example, or congressional committees by their full bodies.

Blame-avoiding behavior also helps to explain why policies are so difficult to change even when they have failed. If policymakers and their constituents perceived costs and benefits symmetrically, they would be willing to change policies quite freely, at least as long as the new policies promised as high a surplus of concentrated benefits over costs as the status quo. But substantial vested interests often develop around programs. Because of the negativity bias, policymakers fear that new policies will not win them as much support as eliminating the old ones will lose. They are thus afraid to dismantle failed policies, and when they do, they may "grandfather" in current beneficiaries so that they do not become losers.

The impact of blame-generating and blame-avoiding behaviors on the practice of democracy is, however, more important than their effect on any specific policy. A key tenet of democracy holds that voters must have accurate and adequate information if they are to make informed choices. Yet fear of blame causes politicians to be vague in their public statements about where they stand, especially on issues that divide their constituencies. The prevalence of negative advertising during political campaigns increases the amount of information that voters have about their public servants. But much of it is biased and distorted, making it difficult for voters to be confident that they have the information they need.

Politicians' desire to avoid blame also means that societal interests are likely to be represented unequally. Groups that have a stake in the status quo and would suffer losses from policy changes are more likely to be vocal and to be listened to than those who would benefit from the change. For those who believe that government should attempt to maximize public welfare only if doing so does not make some individuals worse off, this unequal representation is perfectly appropriate, and it is welcome news. For those who believe that government's role is to maximize the net social welfare even if some losses are imposed on some groups, the prevalence of blame-avoiding behavior is very bad news indeed.

Illustration by Regina Jones

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Federal Aid for People, Not Places

THE FEDERAL GOVERNMENT should restructure its system of grants-in-aid to eliminate programs that help places and expand those that help people, conclude the three authors of *When Federalism Works.*

States and localities should take care of their own economic development, providing aid to places with the greatest economic need, authors Paul E. Peterson, Barry G. Rabe, and Kenneth K. Wong write. Local governments and school districts now often use federal development money to replace local funding of projects they would otherwise support themselves.

The federal government, however, should be responsible for helping people in need, the authors say. It has the resources lacking at state and local levels to fund education for the handicapped or housing for the poor. And because the federal government stands apart from intercity and interstate competition, it is the logical entity to finance programs that serve disadvantaged groups. While federal grant programs for the disadvantaged have not worked equally well at all times, the authors conclude that the programs generally have been effective and efficient.

Peterson is director of the Governmental Studies program at Brookings. Rabe is assistant professor of health politics in the School of Public Health at the University of Michigan. Wong is assistant professor of political science at the University of Oregon. The three men studied nine federal education, health, and housing programs in Baltimore, Dade County (Miami), Milwaukee, and San Diego.

When Federalism Works

By Paul E. Peterson, Barry G. Rabe, and Kenneth K. Wong
$10.95 paper; $28.95 cloth.

Soviet Threat to Iran Overrated

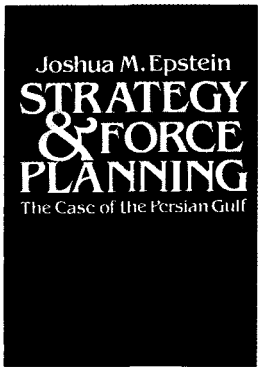
GEOGRAPHY, PRESIDENT REAGAN HAS NOTED, "explains why the Soviet Union has sent an army into Afghanistan . . . and, if [it] could, Iran and Pakistan." Ironically, geography also helps explain why the Soviet Union has so far refrained from an all-out invasion of Iran, Joshua M. Epstein, a research associate in the Brookings Foreign Policy Studies program, writes in *Strategy and Force Planning: The Case of the Persian Gulf.* Iran's "forbidding terrain," the "long distances" from the USSR to the Gulf, and the "limited and vulnerable" transportation system in Iran combine to create "imposing vulnerabilities for a Soviet invasion." The author concludes that the Reagan administration has badly underrated those vulnerabilities and thus exaggerated the Soviet threat.

Epstein challenges the prevailing view that direct conventional defense of Iran is beyond America's reach. Through careful modeling, the author shows how a rapid U.S. deployment force considerably smaller than that planned by the Reagan administration could defend successfully and deter credibly, while avoiding the risks inherent in alternative strategies.

One of those alternatives is to rely on the prospect of nuclear reprisal against targets in the USSR or Iran to dissuade the Soviets. Another strategy, closely associated with the Reagan administration, is to threaten to launch counteroffensives with nonnuclear forces against Soviet targets outside the Persian Gulf theater, such as the Soviet brigade in Cuba. Finding fatal flaws in both escalatory approaches, the author concludes that "neither can provide the basis for a credible deterrent to Soviet aggression." Fortunately, Epstein argues, direct conventional defense is both credible and feasible.

Strategy and Force Planning: The Case of the Persian Gulf

By Joshua M. Epstein
$10.95 paper; $28.95 cloth.



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